Department of Finance
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Ministère des Finances
Canada

Reforming Canada's Financial Services Sector

A Framework for the Future

June 25, 1999

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Table of Contents

1

Introduction and Overview

Task Force on the Future of the Canadian Financial Services Sector

The legislation governing Canada's federally regulated financial institutions is subject to review every five years. At the time of the last review in 1996, Canada's financial services sector was undergoing rapid change. In recognition of this, the government announced that the Task Force on the Future of the Canadian Financial Services Sector would be established to provide advice on the future of the sector.

The Task Force's report was intended to serve as the basis for the next round of revisions to the legislation regulating the sector, scheduled for no later than 2002. Its mandate was to assess and evaluate public policies affecting the financial services sector and to make recommendations to enhance:

- the sector's contribution to job creation, economic growth and the new economy;
- competition, efficiency and innovation;
- the international competitiveness of the sector in light of the globalization of financial services, while at the same time maintaining strong, vibrant domestic financial institutions;

- the ability of the sector to take full advantage of technological advances as they occur and to meet the competitive challenges resulting from the introduction of new technologies; and
- the contribution of the sector to the best interests of Canadian consumers.

In September 1998, after nearly two years of study and consultation, the Task Force concluded that Canada is, for the most part, well positioned to meet and benefit from the changes occurring in the sector. Still, it identified a number of measures that could be implemented to help Canadians and their financial institutions better meet the challenges wrought by change. To that end, the Task Force offered 124 recommendations for enhancing competition and competitiveness, improving the regulatory framework, meeting Canadians' expectations and empowering consumers.

The Task Force's Findings

"Canada is, on balance, well positioned to benefit from a healthy, dynamic, innovative and competitive financial services sector into the next millennium. For a small country in population terms, Canada has many relatively large and successful financial institutions. We believe that they, along with new entrepreneurs in the financial services sector, are capable of positioning themselves so that they will be positive forces in the Canadian economy in the years ahead." [1]

The Task Force, however, recommended that:

- Enhancing competition would make the sector more vibrant and dynamic.
- Empowered consumers would provide an important discipline to competition and make the sector more responsive to their needs.
- Strengthening the relationship between financial institutions and the communities they serve would make the sector healthier.
- Making the regulatory framework more flexible and forward-looking would more effectively balance the need for continued safety and soundness with the need to facilitate competition and innovation.

[1] Task Force on the Future of the Canadian Financial Services Sector, *Change, Challenge, Opportunity: Report of the Task Force,* September 1998, p.3.

The Task Force's report was the subject of intensive public consultations. Two parliamentary committees – the House of Commons Standing Committee on Finance and the Senate Standing Committee on Banking, Trade and Commerce – conducted nationwide public hearings on the Task Force's report.

Between the two committees, close to 200 individuals, firms, associations and consumer groups were consulted. Both committees tabled their reports in December 1998, and both were generally supportive of the majority of the Task Force's recommendations.

Payments System Review

In June 1996, the government also initiated a review of the payments system. The Payments System Advisory Committee was to conduct its review in parallel with the work of the Task Force. The payments system was examined separately because of its highly technical nature.

The purpose of the payments system review was to determine whether access to the system should be broadened, and whether modifications to its governance framework were needed to ensure that it would continue to develop in the public interest. The review identified three public policy objectives for the system: efficiency, safety and the consideration of consumer interests. Balancing these objectives is key to ensuring that the Canadian payments system remains an efficient component of the financial sector.

The government is grateful to the members of the Task Force, the Payments System Advisory Committee and the legislators for the time and study they devoted to the important public policy questions surrounding the Canadian financial services sector.

In the months since the tabling of their reports, the Department of Finance has met with many of the individuals and groups who participated in the Task Force and parliamentary consultations.

The Evolution of the Financial Services Sector

New information technology, globalization and demographic change are driving innovation and giving rise every day to new opportunities and demands in the Canadian financial services sector. The impacts of these changes on consumers, businesses and governments will continue to drive the evolution of the sector in the future.

Technological advances have revolutionized the financial services sector

A significant catalyst of change in financial services has been the development of new technologies, particularly new information technologies. Financial services are information-intensive businesses. Advances in computing and telecommunications continue to improve the speed, security, volume and quality of financial information processing, and to greatly lower the cost of transactions. These technological developments

Canadians are among the fastest adopters of new information technologies

make possible new financial products and services, from telephone and Internet banking to index-linked guaranteed investment certificates (GICs).

At the same time, the convergence of communications and computing technologies leads consumers to expect real-time access to financial services anywhere, at any time. And Canadians have shown themselves to be among the fastest adopters of such new technologies – 57 per cent of Canadian shoppers indicate that they prefer to use debit or credit cards rather than cash in making purchases.

The new information technologies have also accelerated the trend toward freer trade around the world, leading to a truly global market for capital and financial services. As a result, firms now have access to more consumers who, in turn, enjoy greater choice of products and services from enhanced competition.

The trend toward freer global trade has presented tremendous growth opportunities for innovative, competitive firms, and allowed the Canadian financial services sector to make a greater contribution to Canada's export performance. It has also meant that foreign providers of financial services can make greater inroads into the Canadian market.

At the same time, demographic trends in Canada and throughout North America have been further shaping the financial services market, just as they have other markets. In particular, the aging of the "baby boomer" population is having a visible impact on the evolution of the financial services marketplace. Financial institutions are placing increasing emphasis on wealth management services as this generation shifts from its borrowing to its saving years.

The growing ranks of small-business owners and the self-employed also create new markets for financial services since these individuals tend not to be covered by group pension and insurance benefit plans.

A particular challenge for Canada is the shrinking population in small communities. This has implications for how financial institutions maintain national pricing policies while ensuring adequate access to financial services in smaller remote and rural communities.

The sector's responses to these forces are having an impact on consumers, competitors and regulators, simultaneously reinforcing and accelerating change.

Today, financial institutions use sophisticated information technologies to understand their customers, sell their products and, sometimes, sell the products of other firms. While financial institutions prize "brand loyalty" in their customers, many commonly used services, such as deposit accounts, mortgages and GICs, are becoming interchangeable commodities.

As economic borders fall between countries and business lines overlap, firms seek out more strategic alliances to remain competitive. As well, in the drive to achieve scale economies and reduce costs, businesses seek out opportunities for mergers and acquisitions.

These forces will not diminish. The rate of change will not slow. Indeed, it could accelerate. Therefore, it is incumbent upon the government to provide a policy framework that allows this evolution to proceed to the benefit of all Canadians, while preserving the health and strength of the sector.

An overview of the current structure of the financial services sector is provided in Annex B.

Shaping the Financial Services Sector – Guiding Principles

Strong, efficient and profitable financial institutions are vital to Canada's economic success. Over and above their important direct contribution to economic activity, financial institutions are in some way involved in virtually every transaction in the economy: processing payments, pooling savings, financing investment or managing risk.

The men and women who work in Canada's financial institutions are the people Canadians turn to for financial services and advice, and the success of each institution depends on them. As such, they have much to be proud of, for they have ensured that these institutions remain among the most innovative and dynamic companies anywhere in the world. This has occurred in the face of a rapidly changing global environment.

Canada is widely acknowledged for having one of the safest and soundest financial sectors in the world

Canada is also widely acknowledged for having one of the safest and soundest financial sectors in the world. This is a valuable asset in a rapidly changing global economy. Although it is not the responsibility of government to effect change within the sector, it is incumbent upon government to put into place a policy framework that allows the sector to evolve, while preserving its soundness and ensuring that its evolution benefits consumers.

In shaping financial services sector policy, the government has been guided by four fundamental principles. They are that:

- financial institutions must have the flexibility to adapt to the changing marketplace and to compete and thrive, both at home and abroad, in order to retain their role as critical sources of economic activity and job creation;
- vibrant competition is necessary to ensure a dynamic and innovative sector and that individual and business consumers have a range of choice at the best possible price;
- consumers, regardless of their income or whether they live in an urban or rural area, and individual businesses, whether they be large or small, should receive the highest possible standard of quality and service; and
- the regulatory burden should be lightened wherever possible, consistent with prudential and public interest objectives.

Reforming the Financial Services Sector – A Framework for the Future

This paper sets out a comprehensive, balanced package of four interrelated components. They are:

Promoting efficiency and growth with:

- A new definition of widely held ownership that allows strategic alliances and joint ventures with significant share exchanges.
- A new holding company regime to provide greater structural flexibility.
- A transparent bank merger review process with a formal mechanism for public input.
- An examination of capital taxation policy with the provinces.

Fostering domestic competition by:

- Encouraging new entrants with liberalized ownership rules and lower minimum capital requirements.
- Facilitating the ability of the credit unions to compete by allowing a restructuring of their system.
- Expanding access to the payments system to provide additional competition in deposit-like services.
- Allowing foreign banks to offer services to businesses and individual consumers via branches, in addition to subsidiaries.

Empowering and protecting consumers of financial services with:

- Measures to improve access to financial services regardless of income or place of residence, including a standard low-cost account and a process to govern branch closures.
- A Financial Consumer Agency to strengthen oversight of consumer protection measures and expand consumer education activities.
- An independent Canadian Financial Services Ombudsman.
- Measures to prevent coercive tied selling and improve the information consumers receive when purchasing services or making investments.
- Public Accountability Statements for financial institutions to report on their contributions to the Canadian economy and society.
- More and better statistics on and analysis of small and medium-sized business financing to provide a better understanding of their needs.

Improving the regulatory environment by:

- Improving the governance of the payments system.
- Reducing the reporting burden relating to Canada Deposit Insurance Corporation standards.
- Providing the Superintendent of Financial Institutions with new powers to deal with the potential risks arising from increased competition.
- Streamlining the Office of the Superintendent of Financial Institutions' regulatory approvals process.

For clarity of exposition, throughout this document the legislative proposals which the government will be bringing forward for the consideration of Parliament are or may be described as if they were already adopted or in force. These are, of course, simply proposals and will have no force or effect unless and until they are passed by both Houses of Parliament and receive Royal Assent.

2

Promoting Efficiency and Growth

Highlights

The government is acting to provide greater structural flexibility for financial institutions to compete in the global marketplace. A regime to permit large mutual life insurance companies to demutualize is already in place. The government will introduce:

- A new definition of widely held ownership that allows strategic alliances and joint ventures with significant share exchanges.
- A new holding company regime to provide greater structural flexibility.
- A transparent bank merger review process with a formal mechanism for public input.
- An examination of capital taxation policy with the provinces.

Financial institutions manage the investment holdings of Canadians, safeguard their wealth and assist consumers and businesses in financing important purchases and investments. Financial institutions must do this while creating value for their shareholders. This, too, serves the broader Canadian interest because the shares of financial sector companies constitute a large part of major stock indexes, pension fund holdings and the savings of individuals.

Financial services are not only important to the everyday lives of Canadians, they are important contributors to economic growth and job creation. The sector:

- employs more than half a million Canadians;
- provides a yearly payroll of over $22 billion;
- exports nearly $50 billion of services annually;
- represents 5 per cent of Canada's gross domestic product; and
- yields over $9 billion annually in tax revenue to all levels of government.

Canadian banks and insurance companies have been among the export leaders in our economy. Five of our six largest banks have at least 30 per cent of their assets abroad. Two of our major insurance companies have more activities abroad than here in Canada. This generates foreign exchange revenues and high-paying jobs that benefit all Canadians.

Besides being a major industry and source of employment, the firms in the sector provide services critical to Canadian businesses and consumers, facilitating commerce and allocating credit. Because of the sector's direct and indirect importance, the policy framework must promote its potential for growth, exports and job creation to the benefit of the entire economy. The government is proposing a number of measures to increase that potential.

The demutualization of the large mutual life insurers will permit these companies to access the capital necessary for growth and expansion. A new definition of "widely held" ownership will facilitate strategic alliances and joint ventures. A new holding company regime will provide Canada's financial institutions with greater structural flexibility. The merger review process will be transparent and will provide greater clarity and certainty for the institutions considering this strategy. Finally, the government will undertake an examination with the provinces of the current capital tax regime as applied to the financial sector.

Demutualization of Large Insurance Companies

Earlier this year, Parliament passed legislation to permit large federally regulated mutual life insurance companies to convert into stock companies, a process known as demutualization. Canada's four largest mutual insurance companies (The Mutual Life Assurance Company of Canada, The

Manufacturers Life Insurance Company, Sun Life Assurance Company of Canada and The Canada Life Assurance Company) have all announced their intention to demutualize.

The new regime gives these companies the ability to structure themselves differently, subject to the approval of their policyholders, in order to improve their efficiency and competitiveness. As stock companies, they will be able to issue common shares, an important source of financing for corporations that want to grow and expand.

Flexibility is a must in today's rapidly changing global financial services marketplace

Increased ability to raise capital will enable demutualized insurance companies to seize growth opportunities both at home and abroad and make major investments in technology and new products to meet the changing needs of consumers.

Flexibility in this regard is becoming increasingly important given the fierce competition in the global financial services marketplace.

The Widely Held Ownership Rule

The current ownership regime, which requires large banks to be widely held, has served the financial sector well. Canadian financial institutions are generally recognized as meeting high standards of safety and soundness. However, with the passage of time and experience with this regime, the government has come to the view that there are improvements that can be made to the widely held ownership rule to promote growth and foster increased domestic competition, without unduly compromising prudential objectives.

The widely held ownership rule should be improved to promote growth and foster competition

Current Definition of Widely Held Ownership for Banks

The current widely held rule for banks applies to Schedule I banks as set out in the *Bank Act*. Schedule I banks must be widely held, which is defined to mean that no more than 10 per cent of any class of shares of a bank may be owned by a single shareholder, or by shareholders acting in concert.

Over the last 30 years, this rule has been a key instrument in addressing the prudential concerns relating to banks. Having widely held financial institutions is one way to limit the risk of self-dealing. Widely held rules preclude upstream commercial links, which have traditionally been perceived to increase the risk of inappropriate self-dealing, including distortions in credit allocation. Also, widely held banks are subject to a high degree of market transparency and oversight, something that tends to enhance governance and moderate the riskiness of management decisions.

New Definition of Widely Held

The widely held rule will apply to all banks and demutualized insurers whose equity is over $5 billion. Banks and demutualized insurers under $5 billion can be closely held. Chapter 3 elaborates on this new size-based ownership regime.

The banking sector has argued that the current definition of widely held, which limits ownership positions to 10 per cent, is too restrictive. It precludes a widely held Canadian bank from entering into a joint venture or alliance that results in any shareholder having more than 10 per cent of any class of the bank's shares. Banks argue that they should be able to enter into joint ventures and strategic alliances that make good business sense and bring about innovation for the consumer. The government agrees. The new rule will address this constraint.

Going forward, the government will allow an investor to hold up to 20 per cent of any class of voting shares, and up to 30 per cent of any class of non-voting shares, of a widely held bank, subject to a "fit and proper" test.

"Fit and Proper"

Generally, "fit and proper" tests are used to assess the suitability of prospective owners. These tests include an examination of the applicant's past record as a business person, the soundness of their business plan and the reasons why they wish to get into the particular line of business. They also seek to assess that applicants have the necessary integrity and fitness of character. These tests help ensure that key shareholders are not a source of weakness to the regulated institutions.

Canada's large banks must be allowed to develop their strategic vision

It is important that Canada's large banks be allowed to develop their strategic vision, free of any unnecessary constraints and based on the best interests of depositors and shareholders. Allowing a single shareholder, or shareholders acting in concert, to control a large bank is inconsistent with this premise and could lead to situations where the bank's policies are slowly steered away from the best interests of the rest of the stakeholders.

The current *Bank Act* has provisions to prevent any one interest having direct or indirect control of a bank.

The government will review these provisions to ensure they are adequate to preclude control by a shareholder, or shareholders acting in concert, under the new ownership regime.

Widely Held Rule for Demutualized Life Insurers
The new definition of widely held will apply equally to large demutualized life insurers – that is, those with equity over $5 billion.

A Holding Company Structure

A holding company is generally a non-operating company that holds interests in other, generally operating, companies. A holding company structure is currently permitted for financial services providers in the United States, the United Kingdom and many other industrialized countries. In Australia, a recent inquiry into its financial services sector concluded that a non-operating, regulated holding company option should be made available.

In Canada, closely held financial institutions (for example, stock life insurance companies) have always had the option of organizing under an unregulated holding company.

The government will enable widely held financial institutions to organize under a regulated holding company structure.

The holding company option will provide financial services providers with greater choice and flexibility with respect to how they structure their operations. It will also allow them to compete more effectively in the global market by giving them new latitude for raising capital and embarking on strategic alliances.

The holding company option will provide financial institutions with greater flexibility

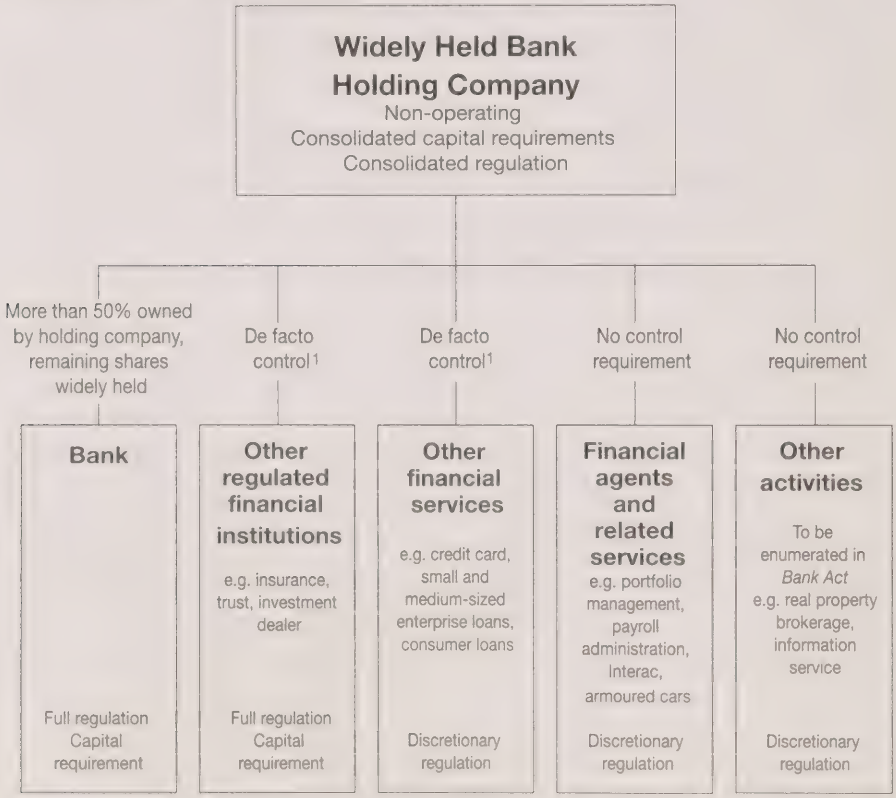
The holding company regime will enhance domestic competition by providing a structure for institutions to come together under a common ownership structure without having to enter into a parent-subsidiary relationship. This will allow them to maintain their separate identities to an extent not possible under an acquisition or merger. For example, a bank, an insurance company and a mutual fund company might find that there are economies of scale and scope if they were to work together within a corporate group.

Holding Companies for Widely Held Banks

A bank holding company structure will be an incorporated entity under the *Bank Act*. Under the proposed structure, banks will have the choice of moving certain activities that are currently conducted in-house, or in a subsidiary of the bank, to an affiliate outside of the bank.

Depending on the risk that the affiliate poses for the holding company's bank, the affiliate could be subject to lighter regulation than the bank. However, there will be oversight of the entire group in order to safeguard regulated affiliates.

Chart 2.1
Widely Held Bank Holding Company Structure



[1] Less than controlling interest permitted subject to minority investment rules or such other tests as may be elaborated

Activities of the Parent Holding Company

The parent holding company will be non-operating. It will be permitted to hold federal financial institutions as subsidiaries, as well as other entities related to financial services or otherwise set out in legislation. The general prohibition on commercial activities that currently applies to banks will apply to holding companies.

Non-Operating Holding Company

A non-operating holding company's activities may include raising capital, subject to prescribed capital rules; investing and managing its cash flow and liquidity; and investing in fixed assets related to its operations. It can also provide certain common services for the other entities in the group. It will not be permitted to undertake any core banking or financial services functions such as credit assessments.

Ownership of the Parent Holding Company

Where a widely held bank chooses to organize under a holding company, the widely held requirement will be applied at the level of the parent holding company.

Permitted Investments for Holding Companies and Parent-Subsidiaries

At the present time, there are restrictions on what banks can invest in or hold as a subsidiary. Certain financial services – such as credit cards and consumer lending – are restricted to taking place within the bank itself.

The government intends to expand the permitted types of subsidiaries so that both a holding company and a parent-subsidiary structure will be permitted a broader range of investments than is currently the case for banks.

This expansion of permitted investment activities will give banks choice and flexibility regarding how they structure themselves, as they will be able to carry out their activities in-house, under a holding company or through a parent-subsidiary structure, without facing significantly different permitted investment constraints. Permitted investments for trust companies and insurance companies will be similarly expanded.

Investment rules will be eased to allow more activities to be conducted outside the bank

The ability to have additional subsidiaries will also permit the creation of new special-purpose entities and facilitate alliances and joint ventures through these entities. This will enhance the flexibility of banks to meet the increasing technological and competitive challenges from sources such as unregulated and "monoline" firms specializing in a single line of business. The new rules will be based on defined categories of eligible investments and a number of key parameters. There will be five broad categories of permitted investments:

1. Regulated financial institutions (e.g. banks, trusts);
2. Firms primarily engaged in providing financial services (e.g. credit cards, small business loans, consumer loans);

3. Entities acting in the capacity of a financial agent, advisor or administrator (e.g. investment counselling, payroll administration);
4. Entities undertaking ancillary, complementary or incidental activities (e.g. Interac service corporation activities, armoured car transportation); and
5. Certain other activities not primarily related to financial services, but specifically enumerated (e.g. certain information services, real property brokerage corporations).

Control requirements, approvals and other rules will be based on the category of investment.

Ownership of Subsidiaries of Holding Companies

Banks held as subsidiaries of the holding company must be *de jure* controlled by the parent holding company. That is, the parent must own a majority of the bank's shares. The remaining shares of a bank subsidiary will be required to meet the widely held criteria.

The government will apply the 20-per-cent limit on voting share ownership and the 30-per-cent limit on non-voting share ownership to the total direct and indirect cumulative ownership of the bank.

This means that no single investor will be able to use the holding company structure to exceed these bank ownership restrictions.

Other regulated financial institutions' subsidiaries would be subject to "control in fact" (where a minority of shares can be held, but control can nevertheless be exercised) by the holding company.

The holding company parent will also be required to "control in fact" subsidiaries that are primarily engaged in providing certain financial services (e.g. credits cards, small business loans, consumer loans). However, less than controlling interest in such firms may be permitted subject to the minority investment rules or such other tests as may be elaborated in consultation with stakeholders.

There will be no control requirement for subsidiaries undertaking advisory or agency activities, those considered ancillary or incidental to financial services, or permitted subsidiaries that are not directly related to financial services.

Regulation of Holding Companies

The government will continue to ensure that appropriate regulatory safeguards are in place. Consolidated supervision at the holding company level will ensure that the Office of the Superintendent of Financial Institutions (OSFI) has an overview of the group's activities. Such consolidated supervision is in line with Canada's commitments under the Core Principles for Effective Banking Supervision established by an international committee of bank regulators (the Basle Committee on Banking Supervision). This includes the ability to review both banking and non-banking activities conducted under the holding company, and having adequate supervisory powers to bring about corrective action.

The holding company group will be subject to consolidated capital adequacy requirements.

These requirements will be consistent with international standards and best practices. Taken as a whole, these capital rules will be applied in a way that permits our banks to remain competitive with regulated institutions in leading countries.

The holding company parent and its downstream holdings will be subject to consolidated supervision with a risk-based focus. This means that supervision will focus on those activities of the group that may pose material risks to the bank and other federally regulated financial institutions which form part of it. This will allow for tailored and flexible supervision based on the particular activities of the group.

OSFI will use its supervisory authorities over the holding company and its subsidiaries on a discretionary basis and as events warrant. Where, for example, a holding company places certain activities such as credit cards in affiliates outside of the bank itself, regulation of such affiliates will be generally lighter than that applied overall to a fully regulated bank. The bank within the holding company, however, will continue to be subject to the full supervisory regime.

Where feasible, in the supervision of non-regulated subsidiaries of the holding company, greater reliance may be placed on transparency and market discipline to ensure that entities in the group remain well managed and well capitalized. However, OSFI will have the authority to issue compliance orders, require special audits and require the holding company to increase its capital where circumstances warrant. If warranted, OSFI could require the holding company to divest a subsidiary or other investments.

Holding Companies for Widely Held Insurance Companies

Canada's four largest life insurance companies (The Manufacturers Life Insurance Company, Sun Life Assurance Company of Canada, The Canada Life Assurance Company and The Mutual Life Assurance Company of Canada) are mutually owned and therefore widely held. They must remain widely held during their transition to stock companies.

A regulated holding company regime, broadly similar to that being established for the widely held banks, will be made available to demutualizing insurance companies.

Holding Companies for Closely Held Financial Institutions

Generally, where a corporate group acquires or sets up a closely held bank, the group will be required to consolidate its financial services related activities, either under the bank or under a regulated bank holding company. This recognizes Canada's commitment to international accords requiring that groups that contain a bank be regulated on a consolidated basis.

Under the new regime, closely held banks will also be allowed to organize under a regulated holding company model.

As is now the case, closely held insurance and trust companies will be able to organize under an unregulated holding company regime. The exception to this will be demutualizing companies that can become closely held after their transition period. They will be subject to a regulated holding company regime under the *Insurance Companies Act*.

A Transparent Merger Review Process

In this era of rapid economic change, technological revolution and globalization, mergers and acquisitions are legitimate business strategies for growth and success. However, given the key importance of the financial services industry, and the largest banks in particular, to the entire Canadian economy, it is essential to ensure that proposed mergers are in the best interests not only of their proponents, but of Canadians and the Canadian economy overall.

To this end, the government will establish a formal and transparent Merger Review Process among banks with equity in excess of $5 billion.

The application of this process would take into account changing circumstances in the condition of the banks. In addition, the process would apply equally to bank holding companies under the new regime. The three criteria on which the government based its rejection of the 1998 bank merger proposals will continue to apply:

> "...(Merger) proposals will first have to demonstrate, in the light of the circumstances of the day, that they do not unduly concentrate economic power, significantly reduce competition or restrict our flexibility to address prudential concerns." The Hon. Paul Martin, December 14, 1998

The process will begin when the banks indicate their intention to merge.

The banks will be required to prepare a Public Interest Impact Assessment (PIIA) as recommended by the Task Force on the Future of the Canadian Financial Services Sector.

Large banks will be required to prepare Public Interest Impact Assessments as part of any merger proposal

The PIIA will provide helpful information for all stakeholders in a merger and serve as an important input to the Minister of Finance's decision.

The PIIA must cover the costs and benefits of the proposed transaction. For example, it must include the impacts on sources of financing for individual consumers and small and medium-sized enterprises. It must also cover regional impacts including branch closures and changes to service delivery, as well as the impact of the merger on international competitiveness, employment and technology.

As well, the PIIA must explain what impact the merger would have on the structure of the financial sector overall; provide an outline of any steps the merging parties intend to take to mitigate adverse effects of the transaction; and cover any other considerations the Minister of Finance may specify. The government will release guidelines setting out in more detail the required contents of the PIIA. The banks will make public their PIIA.

The House of Commons Standing Committee on Finance (Finance Committee) will be asked to consider the PIIA and to conduct public hearings into the broad public interest issues that are raised by the merger as proposed.

Task Force Finding

The Task Force stated, "We believe that public participation in the review of proposed mergers involving very large institutions is essential in light of their public importance."

Task Force on the Future of the Canadian Financial Services Sector, *Change, Challenge, Opportunity: Report of the Task Force*, September 1998, p. 117.

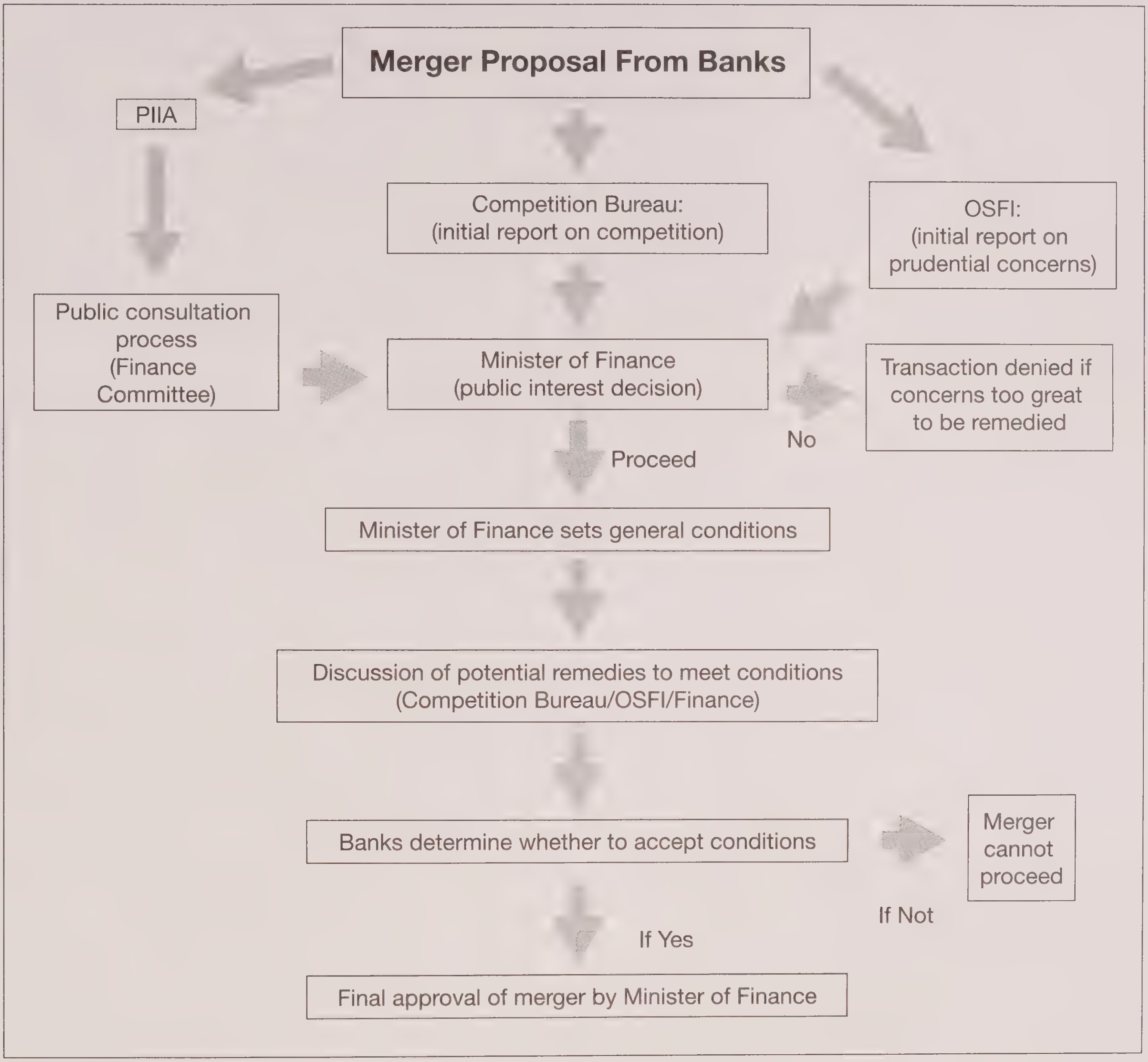
Concurrent with the Finance Committee hearings, the Competition Bureau and Office of the Superintendent of Financial Institutions (OSFI) will conduct their respective reviews of the merger as proposed from the perspective of market competition and the safety and soundness of the merged bank and the financial system.

OSFI will report to the Minister of Finance on prudential issues. The Competition Bureau will provide to the parties and to the Minister of Finance a report setting out the Bureau's views on the competitive aspects of the proposed merger. The Minister will make these reports public. The reports of the Competition Bureau and OSFI would be available for scrutiny by the Finance Committee.

Taking into account these reports, the Minister of Finance will then render a decision on whether the proposal will be allowed to proceed in light of any prudential, competition and other public interest concerns. If the Minister considers that these concerns are too great to be remedied, the transaction will be denied. If the proposal raises concerns which can be met by imposing conditions, the merger will proceed only if those conditions are met.

Under the new process, the Competition Bureau and OSFI will respectively negotiate the competition and prudential remedies with the merger applicants. The two agencies will work with the Department of Finance in the co-ordination of an overall set of prudential, competition and other public interest remedies. It will then be up to the merging banks to decide whether to implement those remedies. If so, the merger would proceed to final approval by the Minister of Finance.

Chart 2.2
Merger Review Process for Large Banks



Legally Enforceable Undertakings

In addition to a new, more transparent merger review process for the largest banks, legislative changes will be needed with respect to the Minister of Finance's authority to impose legally enforceable undertakings in cases of mergers and acquisitions.

A mechanism will be created to bring together a full set of remedies to address competition, prudential and other public interest concerns.

Legislative changes will be introduced to ensure that a financial institution complies with the terms and conditions attached to the approval of mergers and acquisitions and to provide the Minister of Finance with appropriate powers of sanction.

Accounting for Business Combinations

The number and value of mergers and acquisitions have increased significantly over the past several years in North America as companies seek to increase their market share, reduce costs, acquire new technologies and expand their global presence. The financial services sector is one of the leaders in this consolidation trend.

In this environment, the accounting treatment of these business combinations is an important factor. It is generally acknowledged that the Canadian accounting standards in this area can result in lower reported income than the rules that apply in the United States, which can put Canadian firms at a competitive disadvantage relative to their U.S. counterparts in making strategic acquisitions.

The government supports harmonized accounting standards

Accounting standards bodies in Canada and the United States are working towards new, harmonized standards for business combinations by the end of 2000. The government supports this initiative and encourages these bodies to make the necessary changes as soon as possible, and to consider bringing forward an interim solution in Canada to level the playing field. These changes will be beneficial to all Canadian companies, including those in the financial services sector.

If sufficient progress is not made, OSFI will consider what actions could be appropriate to facilitate mergers and acquisitions for Canadian financial institutions.

Taxation

Capital Taxes

The government recognizes that taxes on capital are an important element in determining the competitiveness of our banks. However, in this field, the federal government shares responsibility with the provincial governments.

Capital taxes are an important component of taxes paid by financial institutions, and they have expressed concern that the existing capital tax burden has placed them at a competitive disadvantage vis-à-vis their non-regulated and foreign competitors. Historically, capital taxes have served two policy goals. The first is that they can act as minimum taxes such that financial institutions pay the greater of their income tax and capital tax. The second is that capital taxes provide more stability in government revenue, as the base for capital taxes is more stable than that for corporate income taxes.

This role of capital taxes needs to be reviewed given recent developments and the balance to be struck between these two roles of capital taxes.

The federal government will raise with the provinces the effects of capital taxation on the financial services sector. As part of these discussions, the federal government is committing to a review of its own capital taxes.

Withholding Taxes

Withholding taxes are levied on certain financial transactions between Canadian residents and non-residents. As an example of this, taxes are levied on interest payments to non-resident lenders. In certain circumstances, the withholding tax liability is exempted. For instance, an exemption exists in respect of interest payments on eligible long-term borrowings from unrelated non-residents. This exemption is meant to reduce the costs of Canadian businesses accessing capital from abroad.

Both the Task Force on the Future of the Canadian Financial Services Sector and the Technical Committee on Business Taxation have argued that an extension of the current withholding tax exemption to all interest payments to non-resident arm's length lenders would increase choice and lower prices for Canadian borrowers.

The government is reviewing this issue in the context of its treaty negotiations with other countries, as withholding tax rates are generally established by treaty.

3

Fostering Domestic Competition

Highlights

The government is acting to increase the degree of competition in the domestic marketplace by:

- Encouraging new entrants with liberalized ownership rules and lower minimum capital requirements.
- Facilitating the ability of the credit unions to compete by allowing a restructuring of their system.
- Expanding access to the payments system to provide additional competition in deposit-like services.
- Allowing foreign banks to offer services to businesses and individual consumers via branches, in addition to subsidiaries.

Fostering competition benefits consumers

Strong competition is essential to quality, price and innovation in the marketplace. It is also a necessity if financial institutions are to serve Canadians well and succeed in the international marketplace. Policies to foster competition are among the most fundamental and effective methods for government to promote consumer benefit.

Overall, Canada's financial services sector is already quite competitive. Canadians can choose from a variety of suppliers for a full range of financial services: Canadian chartered banks, foreign banks, credit unions and caisses populaires, life insurers, securities dealers and specialized finance companies.

However, the Canadian banking sector has a poor record of new entry. Since 1987, there have been only two new Schedule I banking charters in Canada, while the U.S., for example, had 207 new banking charters in 1997 alone. The lack of new entry is not in the best interests of Canadian consumers.

The government intends to facilitate new bank entry while at the same time introducing initiatives to strengthen the "second tier" of smaller financial institutions, often community-based, that provide an alternative to the larger financial institutions.

Public policy must strike a balance between the benefits of increased competition and the need to ensure the continued safety and soundness of the financial sector. Measures to increase competition, though certainly beneficial to consumers and to the economy as a whole, may increase risk to the financial system.

It is also important that the supervisory system be capable of ensuring that any increased risks can be appropriately managed. Chapter 5 proposes several enhancements to the supervisory system that provide the necessary tools to discourage imprudent behaviour by financial institutions.

Enhanced Competition

The Task Force concluded that "Canadians will be best served by a dynamic, competitive marketplace, open to the world, with many successful Canadian providers and with opportunities for many new entrants," but that "individual Canadians and small businesses, in particular, are not as well served as they should be and can be."

Task Force on the Future of the Canadian Financial Services Sector, *Change, Challenge, Opportunity: Report of the Task Force*, September 1998, pp. 14-15.

The new ownership regime will make it easier to start a small bank

To enhance competition, the government will establish a size-based ownership regime and reduce minimum capital requirements to facilitate new entry, strengthen the financial co-operative sector, expand access to the payments system, and permit foreign banks to offer services to businesses and individual consumers via branches as well as through subsidiaries.

Encouraging New Entrants

The New Size-Based Ownership Regime

Ownership Rules for Banks

The current ownership rules can present barriers to new bank entry. One way to increase competition is to make the ownership rules less of a hurdle to prospective new entrants.

Current Rules

As noted earlier, Schedule I banks must be widely held.

Schedule II banks may be closely held by certain institutions and individuals subject to a "fit and proper" test. Those eligible to have a significant interest (in excess of 10 per cent of the shares) in a Schedule II bank are:

- a widely held Canadian financial institution other than a bank ("eligible Canadian financial institution");
- a foreign bank or a widely held foreign financial institution ("eligible foreign financial institution"); or
- any person for the first 10 years of the bank's operations.

In addition, Schedule II banks are required to have 35 per cent of their voting shares traded in the public market once equity exceeds $750 million.

The existing rule requires all banks not held by an eligible financial institution to become widely held after 10 years regardless of size. This means that entrepreneurs who take on the risk of starting a new bank are required to sell all but 10 per cent of their shares within 10 years, possibly just when the bank is starting to become profitable. This acts as a disincentive to new entry because many entrepreneurs would not want to start up a business that they must subsequently sell.

New Rules

The new size-based ownership regime will be more welcoming to new entrants. The new rules will be based on size with the widely held requirement applying only to the largest banks, where the concerns regarding the impact of failure on depositors and the wider economy are greatest. Small and medium-sized banks will have the added flexibility of being able to be closely held indefinitely.

The new ownership rules will have three size classifications – small, medium and large – based on the size of the bank as measured by equity.

Equity

"'Equity', in respect of a bank, means the sum of the shareholders' equity of the bank and the minority interests in entities controlled by the bank as they appear in the consolidated financial statements of the bank."
Bank Act, subsection 381(4)

Subsection 381(4) of the *Bank Act* currently defines equity for the purposes of the \$750-million public float requirement. The calculation of equity for the purposes of applying the size-based ownership thresholds will be based on this approach.

Canada's large banks (whose equity is currently greater than \$5 billion) will continue to be widely held, under the new definition of "widely held." As is now the case, eligible financial institutions, that is, widely held Canadian and foreign financial institutions, and foreign banks, will be able to closely hold a bank whose equity grows past \$5 billion.

Medium banks with equity of between \$1 billion and \$5 billion will be allowed to be closely held, but will be required to have a 35-per-cent public float of voting shares.

Publicly floated stocks refer to shares that are listed and posted for trading on a recognized stock exchange in Canada and that are owned by persons who:

- have no significant interest in any class of voting shares; and
- are not entities controlled by a person who has a significant interest in any class of voting shares.

The 35-per-cent public float requirement ensures that any bank with equity over \$1-billion is subject to disclosure requirements under the securities laws in the interest of transparency. This enables the scrutiny of professional market analysts, rating agencies and other stakeholders. The 35-per-cent requirement also serves as a transition stage for a bank as it grows through the \$1-billion threshold and approaches \$5 billion.

Small banks with equity of under \$1 billion will have unrestricted choice in ownership structure.

This means that new banks can be 100-per-cent owned, even by a commercial enterprise, as long as their equity is under \$1 billion.

For existing Schedule I banks with equity of less than \$5 billion, their widely held status will be maintained. However, there may be circumstances where it could be advantageous for one or more of these banks to consider a closely held structure. Therefore, if requested by a bank, the Minister of Finance will have the discretion to change the status of the bank to that of the new regime for banks under \$5 billion.

When a bank grows from one threshold level to the next, it will have three years to make the transition to the ownership rule applicable to its new size category, but may apply to the Minister of Finance for an extension if unusual circumstances prevent it from getting fair value for its shares during the transition period. A similar rule is already in place with respect to the current $750-million threshold.

Table 3.1
Ownership Regime for Domestic Banks

Equity	Ownership restrictions
Large (greater than $5 billion)	Widely held – no shareholder can own, directly or indirectly, more than 20 per cent of the voting shares or more than 30 per cent of the non-voting shares.
Medium (between $1 billion and $5 billion)	35-per-cent public float of widely held voting shares.
Small (less than $1 billion)	No ownership restrictions.

Ownership Rules for Demutualized Life Insurance Companies

There are two broad types of life insurance companies in Canada, distinguished by the nature of their ownership. Mutual insurance companies are owned by their participating policyholders, the people who are covered by the policies that the firm issues. In contrast, stock life insurance companies are owned by shareholders, separating the ownership of the firm, and therefore the raising of capital, from the coverage of the policies that the firm issues.

Since the 1950s, the largest segment of the life insurance sector has been the mutual life insurers. The effect of this has been that, as with our Schedule I banks, they have been widely held. When legislation was passed in 1992, it was specified that large demutualized insurers would remain widely held. Therefore, the widely held concept was extended to these insurers even as they were to be converted to stock companies.

Consistent with the approach to bank ownership, the government believes that there is merit to continuing to have the large mutual life insurers widely held after demutualization. At the time of tabling the recent demutualization legislation, the government announced that it would review the wide ownership policy two years following promulgation of the regulations. The government has decided to define the policy now.

All demutualized insurers will have a two-year transition period following demutualization during which no one shareholder can hold in excess of 20 per cent of the voting shares and 30 per cent of the non-voting shares of the insurer. No mergers among, or acquisition of, demutualized firms will be permitted during the transition period.

This transition period will allow the firms sufficient time to adjust to their new form of ownership. The application of this process would need to take into account changing circumstances in the condition of the companies.

Once the transition period ends, the demutualized insurance companies will be subject to the same ownership regime as banks. As a condition of demutualization, all demutualized insurers that have equity in excess of $5 billion will be required to meet the new widely held rule after the two-year transition period. As with the widely held banks, these companies cannot be acquired.

Large mutual life insurers will continue to be widely held after demutualization

Having these large demutualized companies remain widely held will help ensure the maintenance of a strong insurance sector.

Demutualized insurance companies under $5 billion in equity will retain their widely held status. However, as with the banks, if requested by the institution, the Minister of Finance will have the discretion to change their status to closely held, subject to the 35-per-cent rule.

If permitted to become closely held, demutualized insurers with equity between $1 billion and $5 billion will be subject to the 35-per-cent rule. Demutualized insurance companies with equity of less than $1 billion will be subject to no ownership restriction other than "fit and proper" tests.

Ownership Rules for Trust Companies

Under the current ownership regime, trust companies can be closely held but are subject to a 35-per-cent public float requirement of their voting shares when they reach $750 million in equity. A number of firms have found this to be an effective means of holding an interest in a deposit-taking institution.

The government proposes to maintain this ownership rule for trust companies. However, the threshold will be moved to $1 billion in equity.

Ownership Rules for Stock Life Insurance Companies

Federal stock life insurance companies are not currently subject to a widely held rule, but are required to have a 35-per-cent public float of voting shares if equity exceeds $750 million.

For these firms, the 35-per-cent public float requirement will be maintained, but the threshold will be raised to $1 billion in equity.

Table 3.2
Summary of New Ownership Regime

Equity	Banks	Life insurers		Trust companies	P&C insurers
		Demutualized stock company[1]	**Other stock company**		
Large (greater than $5 billion)	Widely held[2] *Raises current ownership limit from 10% of shares to 20% voting and 30% non-voting*	Widely held[2] *Raises current ownership limit from 10% of shares to 20% voting and 30% non-voting*	35% public float *No change*	35% public float *No change*	35% public float *No change*
Medium (between $1 billion and $5 billion)	35% public float[3] *Threshold raised from $750 million to $1 billion*	35% public float[3] *May become closely held after transition period, with 35% float requirement at $1 billion*	35% public float *Threshold raised from $750 million to $1 billion*	35% public float *Threshold raised from $750 million to $1 billion*	35% public float *Threshold raised from $750 million to $1 billion*
Small (less than $1 billion)	No restrictions[3] *Removes all ownership restrictions for small banks*	No restrictions[3] *No ownership restrictions for small demutualized insurers after transition period*	No restrictions *No change*	No restrictions *No change*	No restrictions *No change*

1 A transition period of two years has been established for demutualized life insurance companies. During the transition period, the companies cannot merge or be acquired.

2 Banks and demutualized life insurers held by an eligible financial institution will not be required to meet the widely held requirement if they grow over $5 billion in equity.

3 Existing banks and demutualized insurance companies below $5 billion in equity will remain widely held. The Minister of Finance will have the discretion to allow them to become closely held.

Ownership Rules for Property and Casualty (P&C) Insurers

Federally regulated P&C insurance companies are also not currently subject to a widely held rule, but are required to have a 35-per-cent public float of voting shares if equity exceeds $750 million.

For P&C firms, the 35-per-cent public float requirement will be maintained, but the threshold will also be raised to $1 billion in equity.

The approach taken to the ownership regime for trust companies, stock life insurance companies and P&C insurers recognizes the fact that the historical development of the ownership structure for these companies has been different than that of our banks and mutual life insurers.

Reduced Minimum Capital Requirements

Governments require a minimum amount of money to be paid into a regulated financial institution. This minimum level of capital is required to ensure that:

- the principal shareholders are strongly committed to the institution; and
- the new financial institution has enough capital to support its operations from the outset, and thereby reduce the likelihood of failure.

The need for substantial minimum capital requirements must be balanced against the desire to encourage new entry. Overly restrictive minimum capital requirements can effectively preclude a range of new entrants to the market. This is particularly true in regions where there are relatively few potential investors with substantial capital.

Easing ownership and capital requirements may lead to the creation of community-based financial institutions

It is the government's view that the current minimum capital requirement of $10 million is overly restrictive and may limit new entry into the market.

In order to address this concern, the minimum capital requirement to start a new bank, trust or insurance company in Canada will be lowered from $10 million to $5 million.

All applicants will remain subject to a full "fit and proper" test before being granted a charter.

It is hoped that the less restrictive ownership requirements and the lower minimum capital requirements will lead to the creation of smaller financial institutions, including ones established to serve their particular community.

Expanding the Financial Co-operative Sector

Canada's caisses populaires and credit unions are member-owned, community-based financial institutions. These local co-operative institutions play an important role in providing financial services to Canadians in every province across the country, often in communities where no other financial institutions are present.

Caisses populaires and credit unions have historically been among Canada's most innovative financial services providers

Historically, financial co-operatives have been among the first in the Canadian market to provide innovative services, such as extended service hours, bank machines, telephone banking and the virtual bank.

However, the structural fragmentation of the credit union system outside of Quebec has been identified as a potential barrier to future growth for the credit union industry. Several specific challenges have been identified in this regard, including:

- the inability to service members moving to other provinces;
- the constraints on opportunities to pool resources and skills among credit unions in different parts of the country;
- the duplication of backroom activities and administrative costs between individual credit unions and between provincial centrals; and
- a lack of co-ordination in areas such as common products and services.

The credit union movement is seeking to meet these challenges with two initiatives:

- Some credit unions are spearheading an initiative to permit them to evolve into a two-tier structure, with enhanced co-ordination.
- Other credit unions are considering a national co-operative bank structure.

The government recognizes that credit unions are an important priority for the provinces and will be seeking their views on these initiatives.

In keeping with the democratic philosophy of governance in the credit union movement, the individual credit unions will be given an opportunity to assess and approve these proposals.

Creating a National Service Entity for Credit Unions

One proposal calls for the current three-tier structure of local credit unions, provincial centrals and the federal central to be collapsed into two by eliminating the provincial centrals. The top tier in the system is to become a new National Service Entity.

These changes will provide a mechanism for participating credit unions to reduce costs, eliminate duplication and overlap, promote stronger co-ordination and create national brands. This will enable them to better meet the needs of their individual members at a lower cost.

To accommodate this initiative, the government will introduce legislative amendments to permit a restructured two-tier system with an enhanced national presence.

Creating a Framework for Co-Op Banks

Several members of the co-op system want to develop a co-operative bank structure under which they could operate on a national basis. One such structure being considered is along the lines of successful co-op bank models in other countries, such as Rabobank in the Netherlands.

The government is supportive of the general direction of these proposals and is prepared to assess legislative steps that can be taken to accommodate a co-op bank structure.

In this regard, the government will work closely with interested credit unions over the next several months as details on their proposals are more fully developed.

The Payments System

Canadians enjoy the benefits of one of the most reliable and efficient paper-based payments systems in the world. In fact, the system works so well that it is largely taken for granted. The efficiency with which cheques and other paper-based payment items are cleared and settled, together with a high level of confidence in the system, allows payees, in most instances, to receive immediate use of funds when they deposit a payment item in their account at a financial institution. This is the case even though settlement does not take place until some time later.

What is the Payments System?

The payments system in Canada is a network of competing and complementary services that facilitates transactions involving the exchange of a means of payment in return for goods, services, real assets and financial assets. The means of payment can take on many forms – from traditional instruments such as currency and chequable deposits in banking institutions, through debit and credit cards, to modern electronic vehicles such as stored-value cards and network tokens in an electronic purse. The instruments, rules, institutions and technical processes that facilitate the transfer of value to discharge the payment obligations, and that govern the intermediary agents involved, form the architecture of the payments system in Canada. As a central element in the economic infrastructure, the payments system has a significant effect on the operating efficiency of the Canadian economy.

In 1996, the government announced that it would undertake a review of the structure and operations of the Canadian payments system. A Payments System Advisory Committee was established, which included individuals from the financial sector, consumer groups and academia. The staff of the Bank of Canada and the Department of Finance published four background papers in support of the Committee's work. These covered a number of areas, including public policy objectives for the payments system, access to the system and system governance.

The review identified three key public policy objectives for the system: efficiency, safety and the consideration of consumer interests. It was recognized that these objectives could be competing. For example, an excessive preoccupation with efficiency might undermine the need to preserve the safety of the system. Thus, the policy challenge is finding the appropriate balance among these objectives.

An important dimension of access to the various payments systems in Canada is membership in the Canadian Payments Association (CPA). Created under federal statute in 1980, the CPA plays a central role in co-ordinating payments system activity. Membership in the CPA is presently limited to federally and provincially regulated deposit-taking institutions.

The CPA operates two national clearing and settlement systems: the Large Value Transfer System, which became fully operational in February 1999 and is designed to handle large-value time-sensitive payments, and

the Automated Clearing Settlement System (ACSS), which handles all other payments. To be a participant in either system, an institution must be a member of the CPA. In the case of the ACSS, CPA members are further differentiated as Indirect and Direct Clearers. To be a Direct Clearer, an institution must account for a minimum of 0.5 per cent of the total national clearing volume. Deposit-taking institutions may also apply to Interac to be a card issuer.

After a review of the competition and prudential issues relevant to the payments system, the government has concluded that access to the system should be broadened to accommodate the entry of life insurance companies, securities dealers and money market mutual funds, provided that the concerns discussed below are appropriately addressed. Since money market mutual funds and securities dealers are provincially regulated, there will be further discussions with provincial regulators to explore rules and conditions under which these institutions can enter the payments system.

The review was based on criteria outlined in the Department of Finance *Payments System Review Discussion Paper* released in July 1998. These criteria were developed to assess potential entrants and to ensure that broader access would not adversely affect confidence in, or the operation of, the payments system.

The first criterion was that potential new entrants be subject to formal regulatory and supervisory oversight to ensure that all payments system participants follow guidelines of prudent behaviour. Life insurance companies meet this criterion, and it is recognized that securities dealers are subject to a form of prudential oversight. While money market mutual funds are not subject to the prudential regulation applied to other financial institutions, the nature of these funds is such that they should not impose significant credit risk on the payments system.

The second criterion requires that potential new entrants have access to an immediate, reliable source of liquidity since payments system participants may, from time to time, have insufficient balances to meet all outstanding obligations. Life insurance companies and securities dealers meet this criterion. For money market mutual funds, access to the payments system will

be conditional on the ability to pledge assets, and borrow up to 5 per cent of a fund's net assets, as permitted by Canadian securities regulatory authorities under their National Policy No. 39, without being required to seek regulatory authorization for each borrowing or asset pledge.

Life insurance companies, securities dealers, and money market mutual funds will be part of the payments system

The third criterion is an appropriate legal foundation for participation in the payments system. Participants need assurance that their rights and obligations will be upheld, both in the normal course of business and in the event of the failure of a member. Securities dealers meet this criterion. However, under the federal *Winding-up and Restructuring Act,* in the event of the insolvency of a life insurance company, the claims of policyholders rank ahead of those of other unsecured creditors. As a result, payments system participants could face relatively higher losses in the event that a participating life insurance company failed. Moreover, there are a number of complex legal issues that may not make it possible for money market mutual funds to be Direct Clearers in the ACSS. To respond to this concern, life insurance companies and money market mutual funds will be eligible to be Indirect Clearers, but not Direct Clearers, in the ACSS system. Collateral, deposit and other requirements that may be imposed by the Direct Clearer will be determined by bilateral agreement.

A final criterion for entry into the payments system is the technical and operational capacity to perform the necessary functions and actually clear items within established cycle times, and to settle balances according to established procedure. The government believes that life insurers and securities dealers have this capacity already. Money market mutual funds that demonstrate the technical and operational capacity to perform as payments system providers may be permitted to become CPA members and to act as Indirect Clearers in the ACSS.

Permitting these new financial institutions to join the CPA will enable them to offer a broader range of services to their clients. This promotes increased competition for the consumer's business. For example, life insurance companies would be able to offer accounts with some of the features of deposit accounts offered by banks, such as cheques or debit cards. With respect to debit cards, authorization would be required by Interac.

Foreign Bank Branching

Legislation has removed an unnecessary regulatory barrier to increased competition by allowing foreign banks to offer specified services in Canada through branches, rather than requiring them to set up separate Canadian subsidiaries. For many foreign banks, this will be more cost-effective. This measure encourages a healthy foreign bank presence, which should in turn lead to a wider range of financing sources for both large and small Canadian businesses, as well as greater choice for some types of consumer lending, such as credit cards or personal lines of credit.

Foreign Bank Activity in Canada

Since 1980, foreign banks have been allowed to establish regulated banking operations in Canada through the incorporation of separate Canadian bank subsidiaries. These subsidiaries have the same business powers as domestic-owned banks and are subject to essentially the same regulatory oversight by the Office of the Superintendent of Financial Institutions. Many foreign banks have established bank subsidiaries in Canada over the last two decades, with foreign banks playing an important role in the Canadian financial services sector. While a few foreign bank subsidiaries engage in retail banking, most offer primarily commercial banking services.

Since reaching a peak of 59 in 1987, the number of foreign bank subsidiaries in Canada has declined to just 42 in 1999. Their share of total banking sector assets, which stood at about 12 per cent in 1990, fell to just under 10 per cent by the end of 1998.

With the passage of legislation in June 1999, foreign banks may operate branch operations in Canada without incorporation.

A healthy foreign bank presence means greater financing sources for Canadian businesses and more borrowing options for Canadian consumers

A foreign bank now has the option of establishing one of two types of branches: either a full-service branch or a lending branch. This allows the level of regulatory requirements to be tailored to the foreign bank's activities in Canada. Neither type of branch is permitted to take retail deposits, defined as deposits under $150,000 (foreign banks that want to take retail deposits in Canada still have the option of doing so through a subsidiary). Full-service branches are permitted to take deposits greater than $150,000 while lending branches are not permitted to take any deposits. In addition, lending branches are restricted to borrowing only from other financial institutions. Since this puts no individual Canadian's funds at risk, lending branches face fewer regulatory requirements than full-service branches.

This initiative pre-dates the establishment of the Task Force on the Future of the Canadian Financial Services Sector. However, the Task Force, as well as the House of Commons Standing Committee on Finance and the Senate Standing Committee on Banking, Trade and Commerce, supported easing the barriers to entry for foreign banks as expeditiously as possible.

The government's foreign entry regime for banks, including those changes made to allow foreign banks to establish branches, will be reviewed in the context of the new framework described in this paper. Any legislative amendments to the foreign entry regime will be made concurrent with the legislative package implementing the new framework. Until the legislation is passed, the current regime for foreign entry will be maintained.

4

Empowering and Protecting Consumers of Financial Services

Highlights

The government is acting to provide better protection for consumers of financial services with:

- Measures to improve access to financial services regardless of income or place of residence, including a standard low-cost account and a process to govern branch closures.
- A Financial Consumer Agency to strengthen oversight of consumer protection measures and expand consumer education activities.
- An independent Canadian Financial Services Ombudsman.
- Measures to prevent coercive tied selling and improve the information consumers receive when purchasing services or making investments.
- Public Accountability Statements for financial institutions to report on their contributions to the Canadian economy and society.
- More and better statistics on and analysis of small and medium-sized business financing to provide a better understanding of their needs.

Consumers benefit from a strong, healthy financial services sector. Confidence in the soundness of financial institutions allows consumers and businesses to transact their daily business efficiently and at relatively low cost. Strong competition is also a fundamental requirement for consumers to be well served, but strong competition alone is not sufficient to provide a satisfactory balance between consumers and providers of financial services.

Task Force Finding

The Task Force concluded: "The current framework for consumer protection is not as effective as it should be in reducing the information and power imbalance between institutions and consumers."

Task Force on the Future of the Canadian Financial Services Sector, *Change, Challenge, Opportunity: Report of the Task Force*, September 1998, p. 15.

Given that financial services are a necessity of everyday life and that consumers and financial institutions do not have the same information, understanding or bargaining power, it is critical that consumers be treated fairly in their dealings with financial institutions.

Financial institutions and the government share the responsibility to help create the conditions for a marketplace of well-informed consumers and competitive suppliers

It is the responsibility of both financial institutions and the government to establish the conditions that create a marketplace of well-informed consumers and a sufficient number of competitive suppliers. Adequate information and range of choice, backed by strong regulatory oversight and an effective redress process, will ensure a relative balance of power between the consumer and the provider and justify consumer confidence in their financial institutions. This, in turn, will deliver the best results for consumers, firms and the economy as a whole.

The Task Force also recognized Canadians' high expectations that financial institutions respond to community needs. It concluded that these high expectations are justified and that financial institutions would be well served to view them as legitimate.

This chapter describes measures being taken by the government to empower consumers and promote greater public accountability of financial institutions. The government will take steps to promote access to financial services, including legislating access to bank accounts, requiring banks to offer a standard low-cost account, introducing a process to manage branch closures, and encouraging greater accessibility of branch services for seniors and the disabled.

The government will also be involved in the establishment of two new agencies to promote consumer interests in the financial sector. First, the government will create a new federal agency – the Financial Consumer Agency – to strengthen oversight of new and existing consumer protection measures and expand consumer education activities. Second, to ensure fair and impartial complaints resolution for consumers, the government will work with financial institutions to launch the Canadian Financial Services Ombudsman.

In addition, the government proposes a number of measures to promote good business practices, including initiatives to enhance transparency and disclosure, improve privacy protection and prevent coercive tied selling. Finally, to encourage greater accountability, financial institutions will be required to report on their contributions to the Canadian economy and society, and the government will introduce a comprehensive regime to collect and analyze data on debt and equity financing to small and medium-sized businesses.

Improving Access to Financial Services

The overwhelming majority of Canadians have access to a wide range of financial services from a variety of providers. Nevertheless, a significant number of Canadians either do not have access to basic financial services or are not able to access services in a manner that adequately meets their needs. Low-income Canadians sometimes find financial institutions reluctant to serve them.

Many Canadians lack access to basic financial services, and many others are not able to access services in a way that meets their needs

The change from personal to electronic service delivery leaves behind those consumers who do not feel comfortable with or cannot use the new technology, and who seek a level of face-to-face service that is becoming less and less available. Promoting equitable access for the less well-off, for seniors and for people with disabilities is an important public policy objective.

Measures to promote access

- Banks will be required to open an account for anyone with certain basic identification.
- Banks will be required to offer and publicize a standard low-cost account.
- Federal deposit-taking institutions will be required to provide at least four months' notice of a branch closure, except in rural communities with only one branch, where six months' notice will be required.
- Federal deposit-taking institutions will be encouraged to improve the accessibility of service for seniors and people with disabilities.

Access to Basic Banking Services

Ensuring that all Canadians have access to basic financial services is an issue of fundamental significance to the government. Consumer research conducted over the past few years indicates that as many as 650,000 adults do not have a transaction account with a financial institution.[1] Yet having an account is increasingly important as cashless transactions become the norm. Without an account to make electronic payments or write cheques, an individual's ability to participate in the economic mainstream is restricted.

In February 1997, at the request of the government, the major banks committed to improving access to basic services for low-income individuals, including a commitment to reduce identification requirements for opening accounts and cashing federal government cheques. Canada Trust agreed to adopt the same policies in January 1998. The government now intends to introduce legislation covering the key elements of this agreement.

Banks will be required to open accounts and cash federal government cheques for any individual who meets certain basic identification requirements, provided there is no reason to suspect fraudulent activity. In addition, neither employment nor a minimum deposit will be required to open an account.

The government also acknowledges the concerns expressed by consumer groups regarding "hold" periods on deposited cheques, which effectively delay the availability of deposited funds until a cheque has cleared. Evidence presented to the Task Force suggested that, in particular, hold periods placed on government cheques are often excessive and constitute a barrier to access.

The Canadian Payments Association is working towards the establishment of end-to-end time frames for the clearing and settlement of cheques. These rules should effectively establish acceptable upper limits on cheque hold periods.

In addition, the government will introduce regulations to require banks to clearly disclose their hold policies to customers.

The government will closely monitor practices regarding holds to ensure that they are reasonable.

[1] Task Force on the Future of the Canadian Financial Services Sector, *Change, Challenge, Opportunity: Canadians' Expectations and Corporate Conduct*, Background Paper #4, September 1998, p. 22.

Access to a Standard Low-Cost Account

A key component of improving access to basic financial services for Canadians is ensuring that such services are affordable. Most major deposit-taking institutions already offer "no-frills" accounts, but consumer groups have expressed concerns about the cost of even these accounts and the difficulty of comparing them across institutions.

In addition, consumer groups have noted that many of the low-cost accounts currently offered require account holders to conduct their transactions largely through electronic service channels such as automated banking machines (ABMs). This has raised concerns about whether such accounts meet the needs of some low-income individuals, the elderly, or Canadians with disabilities, for whom such technology may pose a difficulty.

Given the importance of ensuring that all Canadians can obtain affordable basic banking services, the government intends to introduce legislation requiring banks to offer a standard low-cost account.

Banks will be required to offer a standard low-cost account

This standard low-cost account will differ from the "no-frills" accounts already offered by financial institutions because the basket of services will include a certain number of non-electronic transactions, such as cheques and in-branch transactions. This will provide account holders with some flexibility in choosing how to conduct their banking transactions. The details of the account will be specified in regulation.

At this time, the government contemplates that the standard account will provide 12 transactions for a nominal fee of $3.00 to $4.00 a month. While the account will be available to the general public, the government believes that it will be of particular benefit to low-income individuals.

To ensure that customers are aware of this product, banks will be required to prominently post information about the standard account in every branch.

The government believes that providing a standard low-cost account is an important element of improving access to basic financial services. It is hoped that this initiative, combined with legislating access to accounts, will encourage many individuals who do not have bank accounts to move into the financial mainstream.

The government will also require major federal deposit-taking institutions to report publicly on initiatives that they undertake to facilitate access to financial services for low-income individuals. This will be done through annual Public Accountability Statements that institutions will be required to publish (see section below.) For instance, the Public Accountability Statements might provide examples of activities institutions undertake to educate community groups on account-opening procedures and standard low-cost accounts.

Access to Branch Services

Technological innovation, competitive forces, the population decline in many rural and inner-city areas, the relative decline in deposits as a savings vehicle and the increasing popularity of electronic service delivery channels have created pressures for financial institutions to rationalize their branch networks. This has been achieved by closing branches and reducing operating hours and in-branch services. Such rationalization can have a significant impact on certain groups in society, including small businesses, rural Canadians, low-income individuals, seniors and people with disabilities.

Branch Closures

The closure of a branch of a deposit-taking institution can have varying impacts on customers. It can range from the mild inconvenience of having to switch to a nearby branch of the same institution in urban areas, to the complete loss of service when the last branch closes in a small town. Some stakeholders have recommended that government approval should be required for branch closures and, in certain cases, that the government should prohibit banks from closing branches. The government believes that such measures would impose unwarranted constraints on financial institutions' ability to pursue efficiencies and adapt to change.

Deposit-taking institutions will be required to provide notice of a branch closure

However, to facilitate adjustment to branch closures, a formal closure process is desirable. Currently, a federal deposit-taking institution wishing to close a branch is only obliged to inform customers of the location to which their accounts have been transferred.

The government will require federal deposit-taking institutions to provide four months' notice of branch closures to customers. Institutions will also be required to post notice of the closing date in the affected branch.

The government recognizes that four months' notice may be insufficient for many rural communities, which are often served by only one deposit-taking institution. In such cases, the closure of a branch results in a complete loss of service. These communities need more time to explore possible options for maintaining financial services in the community.

Therefore, in rural areas where there are no other financial institutions within a 10-kilometre radius of the branch being closed, federal deposit-taking institutions will be required to provide six months' notice of closures.

Rural communities need time to explore options when a bank branch closure results in a complete loss of service

This would include notice to customers, local authorities and local newspapers, as well as notice of the closing date posted in the branch.

This will give community residents and leaders a better opportunity to engage the institution closing the branch in discussions on possible alternative service delivery with that institution. It would also allow a community to approach other financial services providers.

The government expects that deposit-taking institutions will respond positively to requests by affected customers and community leaders to hold discussions on branch closures. However, given the particularly negative impact that a branch closure could have on a small town or low-income inner-city area with only one branch of a deposit-taking institution, the government wants to ensure that, in such situations, consumer and community leaders' requests for meetings are met.

The government will introduce regulations providing the new Financial Consumer Agency (described below) with the discretion to convene a consultation if there are concerns that such a rural or inner-city closure is taking place with insufficient consultation.

To promote greater accountability with respect to branch closures, large federal deposit-taking institutions will be required to report publicly on branch openings and closings in their Public Accountability Statements (see section below.)

Access to In-Branch Services for Seniors and People With Disabilities

Reductions in the operating hours of deposit-taking institutions and the availability of face-to-face services are issues of concern to many consumers, particularly seniors. Despite the growing popularity of electronic banking channels and the efforts of deposit-taking institutions to educate consumers on the advantages of these service channels, many seniors are not comfortable with using these new technologies and prefer to deal with an employee. That is why the government has included a certain number of traditional non-electronic transactions as a feature of the standard low-cost account described above.

Some stakeholders have recommended regulating branch operating hours and staff levels. The government believes that regulation in this area could serve to hasten the closure of some branches, which would leave many towns and urban neighbourhoods worse off. It could also cause institutions to alter their plans for the opening of new branches or service points.

The government wants federal deposit-taking institutions to be wheelchair accessible

Concerns have also been expressed by some consumer groups that deposit-taking institutions are not adequately meeting the needs of people with disabilities. For example, not all branches are accessible to individuals in wheelchairs.

Federal and provincial human rights legislation provides a framework for promoting access to facilities and services for disabled persons. Many branches of deposit-taking institutions have taken steps to provide better access to facilities, such as providing ABMs with features like lower keyboards or Braille keypads, or providing sitting areas or lower counters for seniors and people with limited mobility. Moreover, when renovating branches, deposit-taking institutions are incorporating accessibility features that meet or exceed the Canadian Standards Association's voluntary standards.

In addition, deposit-taking institutions are making efforts to provide products and services that accommodate the needs of their customers with disabilities. For example, they are offering large print cheques or bank statements printed in Braille. The availability of electronic service channels, such as telephone and Internet banking, also makes financial services more accessible to persons with disabilities. Despite the very significant and commendable progress made in this area, there is still room for improvement.

The government wants federal deposit-taking institutions to place a high priority on ensuring that all their branches are wheelchair accessible, particularly when no nearby branches of the same institution are accessible. Progress in this area will be monitored before the next review of financial sector legislation.

To promote greater accountability and raise public awareness, the government will require major deposit-taking institutions to report publicly on initiatives to improve accessibility for seniors and people with disabilities in their Public Accountability Statements described below.

The Availability of Micro-Credit

Micro-credit generally refers to small loans made to low-income individuals to sustain self-employment or to start up very small businesses. Although there is no standard definition of micro-credit, in practice, such loans are quite small, amounting to a few thousand dollars.

There are a number of micro-credit programs in Canada offered by dedicated micro-credit providers, most of which are sponsored by private organizations. The government also participates in the micro-credit market, offering micro-financing through some federal government programs and institutions, including Human Resources Development Canada, the Business Development Bank of Canada and the regional development agencies.

The government recognizes the valuable contribution made by private sector micro-credit programs in assisting individuals, unable to access credit from other sources, to find the small amounts of capital needed to become more self-reliant. It will play a role in facilitating the sharing of information on and among micro-credit companies in Canada. Such information has been compiled by the Entrepreneurship and Small Business Office of Industry Canada and is available on the Strategis Web site. The Office will continue to work with micro-credit providers to build upon this information.

The government shares the Task Force's belief that there is scope for the productive expansion of existing micro-credit programs and the support of new programs, consistent with the need to keep their local, community-based focus. It acknowledges that financial institutions themselves have made substantial efforts to assist privately sponsored micro-credit programs. The government encourages financial institutions to continue to explore partnerships and other means of working with micro-credit providers.

Improving Oversight and Consumer Awareness – the Financial Consumer Agency

The government is introducing a number of measures to improve the relationship between consumers and financial services providers. For these to be successful, the presence of an effective oversight regime is essential.

A new Financial Consumer Agency is being established to oversee consumer interests

At present, various parts of the federal government are involved in oversight of the financial sector, including the Office of the Superintendent of Financial Institutions (OSFI), the Department of Finance, Industry Canada and the Canada Deposit Insurance Corporation. In addition to monitoring compliance with regulation and self-regulation, these departments and agencies also play a limited role in assisting consumers who have questions about the financial sector and in providing information on certain financial products and services, such as credit cards and service charge packages on accounts at deposit-taking institutions.

Consumer groups have expressed a desire for better protection in their dealings with financial institutions. In response, the government will consolidate and strengthen existing oversight activities currently dispersed among various federal entities.

The government will establish a Financial Consumer Agency (FCA) that will report to the Minister of Finance.

The FCA will enforce the consumer-oriented provisions of the federal financial institution statutes, work that is currently done by OSFI. This will serve to ensure that consumers, in their day-to-day dealings with financial institutions, fully benefit from the consumer protection measures that the government provides for in legislation. The FCA will have the authority to impose penalties on financial institutions for systematic non-compliance with these measures.

The FCA will also monitor and report on industry self-regulatory initiatives. From time to time, the government has worked in conjunction with the industry to develop self-regulatory codes and practices. The government believes that these initiatives need to be monitored more vigilantly by an independent oversight body to ensure they are meeting the consumer protection objectives of both government and industry.

Beyond these compliance activities, the FCA will undertake to promote greater consumer awareness of the financial system. To this end, it will play a central role in consumer education.

It will also provide one-window access to consumers seeking information about financial services by publicizing its role in consumer protection, responding to consumer enquiries, and properly directing consumers with complaints and enquiries about financial services to other responsible bodies.

Further, the FCA will play a role in initiatives undertaken to improve transparency and disclosure of information about financial products, as discussed in the section on transparency and disclosure below.

To ensure that the structure of the FCA best meets the needs of Canadian consumers of financial services, the government will seek consumer group input on the establishment of the Agency. Going forward, the FCA will regularly consult with consumer groups and financial institutions to promote a consumer-responsive oversight regime.

The government believes that the FCA will play a meaningful role in ensuring a balanced relationship between consumers and financial institutions.

Financial Consumer Agency Responsibilities

- Administer consumer-oriented provisions of federal financial institution legislation (effective enforcement regime)
- Monitor and report on industry self-regulatory initiatives (compliance audits, mystery shopping)
- Provide a single consumer information window (1-800 number to respond to and direct consumer enquiries, Web site)
- Improve consumer education (consumer financial literacy)
- Consult with consumers and financial institutions (consultation on effectiveness of consumer protection framework)

Effective Redress – A Canadian Financial Services Ombudsman

As discussed above, the focus of the new Financial Consumer Agency will be on ensuring that financial institutions respect their various consumer-related obligations and on informing the public about financial services. Its main objective will be to ensure the rights of consumers as a group are respected. Therefore, while the FCA will provide information and referral services to individual consumers, it will not offer redress services for individual consumer complaints against specific financial services providers.

An independent, dedicated body is necessary to handle individual consumer complaints

Given the complexity of a comprehensive complaints resolution scheme, the government believes a separate, dedicated institution is necessary to handle individual consumer complaints.

The banking and life insurance sectors currently provide consumer redress mechanisms. Since 1996, the Canadian Banking Ombudsman has been helping to resolve complaints from small businesses about bank services. Its mandate was expanded in 1997 to encompass personal banking complaints. In 1998, the Canadian Life and Health Insurance Association introduced an Ombudservice to provide informal conciliation for consumers with a complaint about a life insurance company.

The Task Force and several stakeholders have called for a legislated financial services ombudsman. However, many consumer groups have expressed concerns that this would result in a legalistic and non-consumer-friendly approach to dispute resolution. They have told the government that they are supportive of an industry-run ombudsman scheme like the Canadian Banking Ombudsman model, but with certain enhancements. Specifically, they would prefer a single ombudsman office for customers of all financial institutions to improve the visibility of redress services and thereby facilitate access for consumers. In addition, they believe that the ideal ombudsman scheme would have a high degree of independence from the industry and would be perceived by consumers as such.

In response, the government will work with financial institutions to establish the Canadian Financial Services Ombudsman (CFSO). It will be designed to accept all financial institutions and be incorporated as a not-for-profit corporation, funded by its members.

The government will require banks to join the CFSO. Other federally incorporated financial institutions will be required to be members of a third-party dispute resolution system. These institutions, as well as provincially incorporated financial services providers, will be eligible to join the CFSO if they wish to do so.

The CFSO will operate independently of any financial institution, with a Board of Directors that has a majority of non-financial institution representatives. Specifically, the Board of Directors will have eight independent directors and four directors appointed by the member financial institutions. The term of appointment for directors will be three years. The Board will appoint the Ombudsman and approve the CFSO's annual budget.

The Minister of Finance will play a key role in setting up the CFSO and will have an ongoing role in ensuring the independent operation of the organization. However, the Minister of Finance will not be involved in the day-to-day operations of the CFSO.

In particular, the Minister of Finance will approve the organization's letters patent and by-laws and any amendments to them, including its mandate and terms of reference. Further, the Minister of Finance will initially appoint all of the independent directors. Thereafter, a process will be established for the Minister of Finance and the incumbent independent directors to select new independent directors.

The CFSO will have the power to recommend awards to aggrieved customers. While the recommendations will not be binding on the customer or the financial institutions, if an institution does not comply with a recommendation, the Ombudsman will publicize the fact, naming the institution. Accordingly, the government fully expects that financial institutions will comply with the CFSO's recommendations.

In addition, the CFSO will provide an annual report to the Minister of Finance and the public on the number of complaints it receives, the results of its involvement and the time it takes to address complaints.

While resolving consumer and small-business complaints, the CFSO may deal with matters that are governed by the federal financial institution statutes. In order to ensure that the FCA is aware of any systematic violations of the safeguards provided to consumers under federal financial institution legislation, there will be close communication between the FCA and the CFSO.

Promoting Good Business Practices and Accountability

Transparency and Disclosure

The transparency and disclosure of financial service sales documents and contracts affect consumers' ability to understand the nature of the contract they are entering into, and therefore their ability to negotiate and defend their interests.

Disclosure determines what information is provided to the consumer, whereas transparency is concerned with the clarity of that information. The higher the level of transparency and disclosure, the easier it is for consumers to comparison shop for financial services and to benefit from a competitive financial services marketplace.

The level of transparency and disclosure in many financial service consumer contracts and marketing documents in Canada falls short of what Canadian consumers have a right to expect and what industry is capable of delivering.

The federal government will hold discussions with the provinces and the industry to work towards enhancing transparency and disclosure of financial service sales documents and contracts. This work would include developing model contracts and benchmarking best practices for financial institutions to adopt. The federal government will also amend the federal financial institution statutes to provide for regulation-making authority governing disclosure.

This will permit the government to respond in areas where a need for improved disclosure is identified as new products and services emerge in the marketplace.

At this time, the government intends to regulate the disclosure of the risks associated with index-linked deposit products offered by federal deposit-taking institutions.

These products are more complex than traditional interest-paying savings vehicles because their rate of return is tied to a stock market index. Although the client's principal is guaranteed, they may not understand the risk that they may obtain no return on their investment.

Personal Privacy

In today's environment, where new information technology permits easier access to personal data, the government recognizes the importance to consumers of knowing why information is collected and how it will be used and stored. Consent is key if information is to be used for a new purpose or disclosed to third parties. The government also understands that consumers want access to information concerning them and rights of recourse if information is misused.

Consumer privacy will be further protected in law

On October 1, 1998, the government introduced Bill C-54, the *Personal Information and Electronic Documents Act.* Part 1 of the Bill, *The Protection of Personal Information in the Private Sector,* is designed to protect the privacy of personal information that is collected, used or disclosed in the private sector. This legislation will ensure comprehensive and uniform privacy protection for all consumers by requiring organizations to establish and implement procedures to protect customer information.

With respect to consent, the proposals in Bill C-54 will require organizations to obtain "meaningful" customer consent for the collection, use and disclosure of personal information. Although organizations will have the flexibility to obtain consent either expressly or by implication (implied consent), they will be required to take into account the sensitivity of the information and the purposes for which it will be used in determining which form of consent is reasonable.

The legislation will provide a comprehensive oversight and redress regime that will allow consumers, including consumers of financial services, to challenge an organization's compliance with the law, and give the Privacy Commissioner powers to investigate organizations' practices and publicize findings. The Canadian Financial Services Ombudsman will refer specific complaints about privacy to the Privacy Commissioner. The Ombudsman will also keep the Commissioner informed of any more general concerns brought to his or her attention about the privacy practices of financial institutions.

These measures will provide an incentive for financial institutions to seek express consent wherever possible. For the time being, this private-sector-wide approach should prove sufficient to protect the privacy of consumers in their dealings with financial institutions.

Coercive Tied Selling

Coercive tied selling occurs when a firm uses coercion to require a customer to buy one product as a condition of purchasing another one. Concerns have been raised that the special nature of the relationship between financial institutions and their customers renders customers particularly vulnerable to coercion.

In response to these concerns, since 1998, the *Bank Act* has prohibited a bank from coercing or imposing undue pressure on a customer to purchase another financial product from it as a condition for obtaining a loan.

The government believes that concerns about coercive tied selling are justified in light of conditions in today's marketplace. Therefore, the government will broaden the scope of the coercive tied selling provision.

Coercive tied selling of any product will be prohibited

It will be extended to prohibit a bank from coercing or imposing undue pressure on a customer to purchase a financial product from the bank as a condition of obtaining any other product, rather than just loans. In addition, the government will require banks to disclose to consumers the fact that coercive tied selling is illegal, prior to entering into a combination of financial transactions.

Business Powers

While the government is announcing today that it will be implementing measures to foster competition and promote consumer interests, it will take some time for these regimes to be fully effective.

Therefore, the government agrees with the House of Commons Standing Committee on Finance that these regimes should be given time to work before any changes can be considered to bank business powers in the areas of car leasing and insurance networking.

Public Accountability

Financial institutions play an important role in the communities they serve, but there is no commonly accepted way for them to report on their performance in order to provide a basis for discussion with the public on community needs and expectations.

Some community groups have recommended that the government introduce legislated community reinvestment requirements, similar to what exists in the United States under the *Community Reinvestment Act*. The government agrees with the Task Force and the parliamentary committees that such a regime is not warranted in Canada, but that other mechanisms could be used to promote accountability. The Task Force recommended that large financial institutions be required to report on their contributions to society in a manner that "would allow Canadians in all regions of the country served by the institutions to be able to relate the information to circumstances relevant to them."[2]

[2] Task Force on the Future of the Canadian Financial Services Sector, *Change, Challenge, Opportunity: Canadians' Expectations and Corporate Conduct*, Background Paper #4, September 1998, p. 47.

The government will require federal financial institutions with equity in excess of $1 billion to publish annual Public Accountability Statements.

The statement will describe an institution's contributions to the Canadian economy and society and will include:

- the national dollar amount of charitable donations and examples of philanthropic activities;
- employee volunteer activities;
- examples of funding provided to local government and voluntary agencies for community works;
- investments or partnerships in micro-credit programs;
- small-business financing initiatives such as venture capital programs, and dollar amounts of small business lending – broken down by loan size and reported by region;
- initiatives to improve access to banking services for low-income individuals, seniors and people with disabilities;
- the location of openings and closings of branches;
- the number of individuals employed; and
- taxes paid to federal, provincial and municipal governments.

Financial institutions will be required to make these statements available to the public, through their branches or Web sites, for example.

The government believes that the Public Accountability Statements, coupled with the other consumer-oriented measures outlined in this paper, will encourage financial institutions to be responsive to the needs of the communities they serve.

Financing Small and Medium-Sized Business

Ensuring that small and medium-sized enterprises (SMEs) have reliable access to capital is an issue of great importance for the government. The government is committed to creating an environment that is conducive to the creation and growth of small-business ventures because they will continue to be a major engine driving economic prosperity and job creation in Canada.

Small and medium-sized business is a major engine that drives economic prosperity and job creation

The government acknowledges the concern that there is inadequate information on the financing needs of SMEs and the supply of financing available to them. More comprehensive information is needed for the development of effective public policy in this area.

Significant progress has been achieved in recent years regarding the collection of data on bank financing of SMEs. The Canadian Bankers Association (CBA) now publishes detailed quarterly statistics on the lending activities of the major banks, with a particular focus on SME lending. It has also sponsored an annual survey of SME perspectives and attitudes.

However, while banks are the dominant players in the SME finance market, they represent only about half of the debt financing supplied to SMEs. Several other industry groups, including the Canadian Venture Capital Association and the Canadian Finance and Leasing Association, also provide regular reports of their members' activities in financing SMEs. More information is needed regarding other suppliers and equity financing for SMEs to ensure that any gaps that exist in the market can be effectively addressed.

To this end, the government will undertake a comprehensive program of information collection and analysis to ensure that there is adequate information relating to the financing needs of SMEs for effective public policy development. Statistics Canada will be given the mandate to collect and publish data on the supply of debt and equity financing to SMEs.

The data collection program will build on the existing CBA banking data by expanding the scope and coverage to include all types of SME financing and all suppliers of SME financing. The government will determine the details of the information collection program in consultation with data providers and potential users in the community.

To expand the government's analytical capabilities, Industry Canada will be given the mandate to establish a dedicated SME Finance Group that would be responsible for analyzing the Statistics Canada data, conducting other surveys and undertaking continuing research on SME financing issues. Industry Canada will also report annually to the House Standing Committee on Industry regarding the state of SME financing in Canada.

There were also a number of Task Force recommendations directed toward financial institutions to enhance their relationship with SMEs. These include working to reduce turnover of account managers, decentralizing credit granting processes (including meaningful delegation to the local level) and striving to make credit available to higher-risk borrowers, with appropriate pricing and more innovative financing packages.

The government agrees that these issues are an important element of ensuring that SMEs have access to adequate financial resources, and it encourages financial institutions to implement these recommendations to the extent possible. There are other elements of this new framework that will assist SMEs to obtain capital, particularly foreign bank branches, stronger credit unions and new locally oriented banks.

These elements, combined with an improved redress mechanism for SMEs, will result in a better relationship between small business and the institutions that provide their financial services.

Financing Aboriginal Businesses

The Task Force acknowledged the special challenges often faced by Aboriginal enterprises in securing financing, and made recommendations towards improving access to capital for these enterprises. In particular, the Task Force endorsed the recommendation of the National Aboriginal Financing Task Force that, subject to the consensus of First Nations communities, the government should amend federal legislation to facilitate the provision of credit by financial institutions to Aboriginal individuals and institutions by allowing the use of on-reserve personal property as collateral.

Currently, section 89 of the *Indian Act* prohibits the seizure of on-reserve real and personal property by banks, thereby making it difficult for Aboriginal businesses located on reserves to offer collateral when seeking loans. Amending this section of the Act is a delicate matter, and the government and First Nations representatives have agreed that any future changes to the Act must be mutually agreed upon. Therefore, the government is not in a position to make unilateral amendments to the legislation.

Although there are no plans to amend the *Indian Act* at this time, the government is working with financial institutions to explore ways of operating within the current constraints. The CBA has established a working group to clarify issues relating to the regulatory framework for financing of Aboriginal communities and enterprises. This working group also includes government representatives.

Financial institutions are developing innovative and tailored financing programs that meet the needs of Aboriginal businesses

The government acknowledges the progress made in recent years to support the financing of Aboriginal businesses. A number of special financing institutions have emerged, including Aboriginal Capital Corporations, First Nations credit unions, and the First Nations Bank of Canada. Many of Canada's major financial institutions are also actively involved in the financing of Aboriginal business; some have established special business units dedicated to this purpose. The government encourages financial institutions to continue to develop innovative and tailored financing programs that meet the needs of these small businesses.

Other Benefits for the Consumer From the New Policy Framework

- A more flexible and innovative financial services sector able to offer new products and services.
- Additional choice and competition from new entrants, the co-operative credit movement and the new participants in the payments system.
- A set of Canadian financial institutions that are regulated in order to maximize their ability to serve the public.

Scope of Application of Consumer Measures

The measures that the government will take to strengthen consumer protection in the financial services marketplace will apply to most of the large financial institutions serving Canadians. However, the new federal requirements will not apply uniformly to all financial services providers because of the constitutional division of powers between the federal and provincial governments.

Constitutional jurisdiction over consumer protection in the financial services sector is shared between the federal and provincial governments

Constitutional jurisdiction over consumer protection in the financial services sector is shared between the federal and provincial governments, depending on the financial institution in question and the activity being carried on by the institution. The federal government has exclusive authority over banks and shares authority over federally incorporated trust and loan and insurance companies.

In general, provinces have the jurisdiction to regulate the day-to-day business activity of federally incorporated non-bank financial institutions. Other financial services providers, including provincially incorporated trust and loan and insurance companies, credit unions, mutual funds and securities dealers fall under provincial jurisdiction.

Scope of Application of Consumer Measures

Consumer measures	Banks	Trust and loan companies[1] (federally incorporated)	Insurance companies[2] (federally incorporated)
1. Compulsory membership in Canadian Financial Services Ombudsman or external dispute resolution scheme	✔	✔	✔
2. Public Accountability Statements	✔	✔	✔
3. Generic disclosure clause	✔	✔	✔
4. Disclosure of risks related to return on index-linked deposits	✔	✔	n/a
5. Branch closure notification	✔	✔	n/a
6. Access to basic banking services for low-income individuals	✔	✔[3]	n/a
7. Standard basic account	✔	✔[3]	n/a
8. Prohibition on coercive tied selling	✔	some provincial legislation[4]	some provincial legislation[4]
9. Comprehensive privacy legislation (Bill C-54)	✔	✔	✔

1 Federally incorporated trust and loan companies represent 90 per cent of the assets of the trust and loan sector.

2 Federally incorporated insurance companies represent 90 per cent of the assets of the insurance sector.

3 The federal government will work with the federal trust industry to develop codes of best practice.

4 B.C.'s *Financial Institutions Act* prohibits tied selling by trust and loan companies. Tied selling by insurance companies is prohibited in Quebec and B.C. Saskatchewan is considering an amendment to their *Insurance Act* to prohibit tied selling. Other provinces (Ontario, Manitoba, Nova Scotia, New Brunswick and Newfoundland) have provisions prohibiting coercive sales practices, but not tied selling specifically.

The above table shows how all of the new federal measures will apply to banks, and how most will apply to the 90 per cent of the trust and loan and insurance industry that is incorporated federally.

With respect to trust and loan companies, most measures will be applied, with the exception of measures 6, 7, and 8. However, the federal government will work with the trust industry to develop industry codes of best practice to ensure that consumers benefit from better access to basic banking services, standard low-cost accounts, and a prohibition on coercive tied selling practices where consumers are not already protected under provincial tied selling legislation.

For federally incorporated insurance companies, a number of measures will apply, including compulsory membership in an external dispute resolution mechanism, Public Accountability Statements and a generic disclosure clause.

A number of other measures will not be applicable as they are directed specifically at deposit-taking institutions. Given the constitutional division of powers, the prohibition on coercive tied selling will not be imposed on federal insurance companies and federal trust and loan companies. The insurance industry, however, has developed a guideline aimed at safeguarding consumers against this practice. In addition, several provinces have legislation prohibiting coercive tied selling by insurance companies.

The measures will not be applied to provincially incorporated institutions such as credit unions, mutual funds and securities dealers, nor provincially incorporated insurance companies and trust and loan companies, given provincial responsibility for these financial institutions.

However, as the Task Force noted, the fundamental interests and needs of consumers do not vary from jurisdiction to jurisdiction. Therefore, the federal government strongly urges provincial governments to adopt consumer oversight measures similar to those outlined in this paper where they do not already exist, and thus extend the benefits of the new consumer protection regime to customers of all financial institutions.

5

Improving the Regulatory Environment

Highlights

The government is acting to make sure that the regulatory environment responds to the evolution of the sector by:

- Improving the governance of the payments system.
- Reducing the reporting burden relating to Canada Deposit Insurance Corporation standards.
- Providing the Superintendent of Financial Institutions with new powers to deal with the potential risks arising from increased competition.
- Streamlining the Office of the Superintendent of Financial Institutions' regulatory approvals process.

Effective prudential regulation protects consumers and minimizes the risk to the financial system. Canada has developed an international reputation for having a safe and sound financial system. In its 1997 Global Competitiveness survey, the World Economic Forum ranked Canada first in terms of the soundness of its banking system.

Canada's regulatory structure is up to date

In order to keep pace with a changing financial sector, the government updated its regulatory regime in successive reviews in 1992, 1996 and 1997. In 1992, cross-pillar ownership was permitted and new in-house and subsidiary powers were conferred on financial institutions. In 1996, OSFI was provided with a legislated mandate, early intervention rules were put in place and the regulatory system was made more transparent.

Additional measures to ease the regulatory burden were introduced in 1997. Taken as a whole, these reviews served to significantly lessen the regulatory burden on the sector in order to reap the benefits of increased competition.

Nevertheless, in this era of rapid change and global competition, the government must continually consider what regulatory changes are needed to ensure soundness and increase effectiveness. This is a complex exercise because, while pursuing enhanced competition, innovation and the protection of consumers, the government must never lose sight of the need to maintain the safety and soundness of the financial system.

To that end, the government will make changes in a number of areas. The governance of the payments system will be improved, regulatory overlap will be reduced, regulation will be adjusted to adapt to an environment in which the importance of competition has increased, and application processes will be streamlined.

Governance of the Payments System

An important aspect of the 1996 payments system review was the governance of the Canadian Payments Association (CPA) and other private payments system such as Interac, credit card and electronic cash systems.

Currently, the members of the CPA are responsible for the Association's day-to-day decision making. With the exception of the Board's chairperson, who is a senior official of the Bank of Canada, CPA directors are elected by the membership. The government's oversight is limited to the approval of its by-laws. The Bank of Canada has oversight responsibilities and enforcement powers over systems that it designates under the *Payment Clearing and Settlement Act*, such as the Large Value Transfer System operated by the CPA. The oversight and its associated enforcement powers require the Bank of Canada to ensure that appropriate arrangements are in place in these systems to contain systemic risk. Payment card associations such as debit card service providers, credit card service providers and electronic money providers are not currently subject to direct oversight by a financial regulator. However, Interac operates under a Consent Order of the Competition Bureau.

In the course of the payments system review, it emerged that the CPA suffered from a perception that it was a closed group of financial institutions, not necessarily guided by broad public interest considerations but by the

interests of its members. That is, the CPA did not take into account the public policy objectives of efficiency, safety and the consideration of consumer interests. The government believes that this issue can be resolved in part by expanding access to the payments system as proposed, and also with increased public input into the system, through an improved governance structure.

In order to improve the governance structure of the payments system, the government will make a number of changes:

The payments system should evolve in a manner that takes the broader public interest into account

- The CPA Act requires the CPA to "establish and operate a national clearings and settlements system and to plan the evolution of the national payments system."[1]

  The mandate will be clarified to better define the Association's role in the payments system and to establish its responsibility to advance the public interest. Moreover, the CPA will be required to facilitate rather than plan the evolution of the payments system.

- **The CPA Board will be expanded from 11 to 15 members. The Board will consist of 11 CPA members (5 bank, 6 non-bank), 3 independent directors and 1 director from the Bank of Canada.**

  Independent directors will be appointed by the Governor in Council on the recommendation of the Minister of Finance. In order to provide a balance between Direct and Indirect Clearers, while recognizing their different roles in the payments system, the government is proposing that there be no more than four Direct Clearers on the Board from each of the bank and non-bank groups. In total, Direct Clearers other than the Bank of Canada can hold a maximum of 8 of the 15 positions on the Board. As is now the case, the director appointed by the Bank of Canada will serve as Chair of the CPA.

- **The Stakeholder Advisory Council (SAC) will be enshrined in the CPA Act.**

  The CPA established SAC in 1996 as an 18-member group to advise the Board on the payments system from the perspectives of a variety of interest groups. All but 3 members are drawn from outside the CPA. While this voluntary forum has been very useful, it could be enhanced if it were supported by a legislative requirement within the Act.

[1] CPA Act, section 5.

- **The Minister of Finance will have a maximum of 30 days following receipt of a new or amended CPA rule to disapprove it, if it is found contrary to the public interest.**

- The Superintendent of Financial Institutions is responsible for making examinations of and enquiries into the business and affairs of the CPA, and for reporting annually to the Minister of Finance on whether the Association is operating in conformity with its Act and by-laws. Based on a review of this role and the governance regime proposed in this document, this examination would no longer be necessary.

  Therefore, the Superintendent will no longer be required to perform an examination of and report annually on CPA activities.

- The use of electronic payments systems is growing rapidly. This provides benefits to Canadian consumers and businesses. However, should these new systems evolve in a manner or to an extent that they become a critical element of the payments system, and a broader public interest arises, then some oversight responsibility would be appropriate.

  Therefore, the Minister of Finance will be given the authority to designate other payments systems for oversight.

- **The Minister of Finance will have the power to issue a directive to the CPA and other designated systems to require a change in a by-law, rule or operating practice which the Minister determines to be contrary to the public interest. New by-laws, or changes to existing by-laws, that result from a directive would be subject to Governor in Council approval.**

Such a directive power would ensure that the policies, by-laws and rules of the CPA and other designated systems are consistent with public policy objectives.

These changes will address the public interest issues raised during the review process while ensuring that Canada's payments system maintains its dynamism.

Consumer Compensation Plans for Deposits and Insurance Policies

The Canada Deposit Insurance Corporation (CDIC) is a government-backed consumer compensation scheme for federally and provincially regulated deposit-taking institutions. The Canadian Life and Health Insurance Compensation Corporation (CompCorp), the consumer compensation scheme for life insurers, does not have government backing. The life insurance industry has recommended that government backing be extended to CompCorp as a way of levelling the playing field. The Task Force reviewed this issue as well and recommended that CDIC and CompCorp be placed on an equal footing.

CDIC and Compcorp

The Canada Deposit Insurance Corporation (CDIC) insures deposits at banks, other federally incorporated deposit-taking institutions and some provincial trust companies. CDIC's board comprises several senior public servants and private sector members appointed by the Governor in Council. The Corporation has the power to inspect its members and, in some circumstances, to take control or acquire the assets of a member institution. As a Crown corporation, CDIC obligations are guaranteed by the government. Since 1996, a credit enhancement fee has been applied to any new borrowings to bring CDIC's cost of debt in line with that of a private sector organization.

In contrast, the Canadian Life and Health Insurance Compensation Corporation (CompCorp) is a private, non-profit corporation established by the life insurance industry to protect life insurance policyholders against the loss of benefits in the event of insolvency. Its board is composed solely of independent directors. It has no regulatory responsibilities and no power to step in over a troubled member institution. CompCorp can borrow from the private sector and from member life insurance companies, but it cannot borrow from the federal treasury.

The government has reviewed this issue on a number of occasions and continues to be of the view that the extent of government backing for compensation schemes of the deposit-taking and life insurance industries does not need to be identical. Deposit insurance is provided to protect the general public against systemic risk. Although life insurance companies may increasingly offer products that compete directly with deposits, only deposit-taking institutions are subject to developments that could lead to system risk issues.

Streamlining Canada Deposit Insurance Corporation Standards

CDIC standards will be updated and streamlined

The Public Accounts Committee, industry groups and others have called for a clarification in the respective roles of CDIC and OSFI to avoid unwarranted duplication in the regulatory system. As the deposit insurer, CDIC engages in a broad range of activities in order to minimize its exposure to loss. Some of these activities may overlap with those undertaken by OSFI. The Task Force focused on CDIC's Standards of Sound Business and Financial Practices, and proposed that the regulatory regime would be more streamlined if the application of these standards were the responsibility of OSFI.

CDIC's Role

CDIC's mandate is to provide deposit insurance, promote standards of sound business and financial practice, and to contribute to the stability of the financial system, for the benefit of depositors while minimizing its exposure to loss. To that end, CDIC annually requires its members to attest, through a self-assessment report filed with CDIC, that they comply with the Standards of Sound Business and Financial Practices in CDIC's by-laws. Currently, there are eight standards, published in 1993, which relate to management of liquidity, interest rate risk, credit risk, real estate appraisals, foreign exchange risk, securities portfolio, capital and internal controls. CDIC provides its members with a booklet of commentary and guidelines on each by-law.

CDIC's standards have been in place for six years, and it is timely to review their role and impact. CDIC and OSFI are consulting with the industry on the possibilities for streamlining the standards.

In addition, CDIC commissioned the Regulatory Advisory Services Group at PricewaterhouseCoopers to assess the effectiveness of the CDIC standards and make recommendations in response to the Task Force. The report indicates that the standards are universally recognized as an effective tool and should continue to be set and administered by CDIC.

The PricewaterhouseCoopers report concluded that there is little or no overlap between CDIC standards and OSFI guidelines, although they may deal with similar subjects. However, the report also concluded that some of the standards need to be modernized and the process for reporting on compliance could be made less burdensome.

The standards by-laws will remain at CDIC and will be updated. A number of changes will be put in place to streamline the associated administrative processes. For example:

- The standards will be reviewed to align more closely with current concepts of risk management.
- The frequency and detail with which compliance must be reported will be reduced in many cases. Institutions that are highly rated for supervisory and deposit insurance purposes will generally not be required to file comprehensive reports every year. For all institutions, it will be made clear that compliance is to be assessed relative to the broad principles in the standards by-laws, and that the booklets are intended to be a source of commentary and guidance, not a detailed code.
- CDIC's opinion on whether an institution is following the standards should take into account the significance of any deficiencies, and non-material deficiencies should not necessarily be viewed as non-compliance. The statutory requirement imposed on examiners (OSFI for federal companies) to provide CDIC with standards compliance reports (section 29 of the CDIC Act) will be amended to address this materiality concept.
- CDIC and OSFI will enhance their co-ordination and information-sharing in order to reduce the reporting burden on institutions.

In addition to the legislative change required to implement these initiatives, most of the revisions to administrative mechanisms will be put in place by December 31, 1999.

Preserving Safety and Soundness in the New Environment

In striking a balance between increased competition and the potential for greater risk in the financial services sector, an efficient supervisory and regulatory framework should provide appropriate incentives for financial institutions to manage their risks prudently.

In 1996, the government introduced an early intervention policy with three main components: 1) a legislated mandate for OSFI that recognizes the need for prompt action by the supervisor and by the institution to resolve problems; 2) Guides to Intervention that make clear to institutions

the actions the supervisor will take if the financial condition of an institution deteriorates; and 3) the power to close a troubled institution while its capital is still positive, i.e. before it becomes insolvent. The government is committed to the principal of early intervention as a means of preserving the safety and soundness of the financial services sector.

In support of the initiatives to promote greater competition in the financial sector, the Superintendent of Financial Institutions will have additional supervisory powers to deal with the potential for increased risk in the system.

There is a balance to be struck between increased competition and the potential for greater risk

These powers would increase the consequences for any institution that fails to meet certain regulatory or supervisory requirements. In particular, the following measures are proposed:

- A new authority that would allow the Superintendent to remove directors and senior officers from office in certain circumstances, such as instances of misconduct.
- A system of administrative money penalties for financial institutions and individuals that fail to comply with undertakings and cease and desist orders, or violate financial institution legislation and regulations.
- Measures to enhance the Superintendent's power to deal with related party transactions of financial institutions.

These measures will support the early intervention regime, the thrust of which is to prevent undue losses to policyholders and depositors.

Streamlining Regulatory Approvals

Federal financial institutions are required to obtain approval from the Minister of Finance or the Superintendent of Financial Institutions before they can complete certain transactions and business undertakings. This approval process helps to maintain the safety and soundness of the financial system and ensures that the activities of the financial institutions are in the public's best interest.

The government is aware that this approval process can be burdensome, which is why several legislative changes have been made over the past few years in an effort to streamline this process. In 1992, financial institutions were provided with broader in-house and subsidiary powers. In 1996, OSFI was provided with a legislated mandate, the entire regulatory system was

made more transparent and an early intervention regime was established. In 1997, the regulatory burden was further eased and consumer protection was improved.

New streamlining opportunities are continually being explored and, as part of this ongoing initiative, OSFI will introduce a new notice-based approval process for many of those transactions currently requiring the approval of the Superintendent.

Under this process, instead of applying for regulatory approval, institutions will file a standard notice with OSFI. There will be a maximum 30-day period for the Superintendent to raise concerns, seek further information or indicate that there will be a delay. If none of these actions are taken, the transaction will automatically proceed. This change is intended to reduce the burden associated with smaller transactions that do not raise prudential concerns.

In addition, in some cases, institutions will need to obtain several approvals under the various financial institution acts in order to complete a single transaction. Mechanisms to permit blanket approvals in such circumstances will be developed in order to streamline the regulatory process.

6

Conclusion

The objective of the financial sector review has been to ensure that the sector best meets the needs of all Canadian consumers of financial services and to provide a policy environment conducive to the growth and success of the financial institutions themselves.

The new financial sector framework meets these objectives:

- **Canada's banks** will benefit from greater flexibility to adapt to the changing business environment, including potential for joint ventures and strategic alliances; a more flexible ownership structure; a new holding company option; a broader range of permitted investments; a transparent merger review process; a commitment to examine capital taxes with the provinces; and streamlined regulatory processes.
- **Canada's trust companies** will benefit from a broader range of permitted investments, the examination of capital taxes with the provinces and streamlined regulatory processes.
- **Canada's life insurance companies** will have access to the payments system, a new holding company structure and streamlined regulatory processes.
- **Securities dealers** and **money market mutual funds** will have access to the payments system.
- **Canada's credit unions** will be able to restructure themselves to enhance their national presence and better serve their members.

- **Consumers** will have guaranteed access to standard low-cost accounts; a process to adjust to branch closures; increased competition for their business from stronger credit unions and new, community-oriented banks; an agency to ensure that financial institutions adhere to consumer protection policies; and access to an independent ombudsman to ensure that they are treated fairly.
- **Small and medium-sized businesses** will benefit from increased choice among financial services providers (stronger credit unions, new banks, and foreign bank branches) and an independent ombudsman. There will also be a more comprehensive database on small and medium-sized enterprise lending and a new analytical group at Industry Canada to ensure a better understanding of their financing needs.

The government will now proceed to draft the legislation required to implement this framework with a view to tabling the legislation as soon as feasible. The legislation governing Canada's federal financial institutions will remain subject to a five-year sunset clause.

In the future, new challenges and opportunities will continue to arise and new ideas will be brought forward, as both the sector and Canadian society respond to the forces of change.

Annex A

Summary of Proposed Measures

Promoting Efficiency and Growth

Widely Held Rule

1. The government will introduce a new definition of widely held. An investor will be permitted to own up to 20 per cent of any class of voting shares, and 30 per cent of any class of non-voting shares, of a widely held bank or demutualized insurer, subject to a "fit and proper" test. (pp. 16-17)
2. The *Bank Act* will be reviewed to ensure that its provisions are adequate to preclude control by any single shareholder, or group of shareholders, under the new ownership regime. (p. 17)

Holding Companies

3. Widely held banks and widely held insurance companies will be able to organize within a regulated, widely held, non-operating holding company. (p. 17)
4. Where a widely held financial institution organizes under a holding company, the widely held ownership rule will apply at the level of the holding company. (p. 19)

5. A broader range of investments will be permitted for both holding company and parent-subsidiary structures to give banks and insurance companies greater choice and flexibility in the structure of their operations. Trust companies will also be permitted to have a broader range of investments. (p. 19)

6. The 20-per-cent limit on voting share ownership and the 30-per-cent limit on a non-voting share ownership will apply to the total direct and indirect cumulative ownership of the bank subsidiary of the holding company. (p. 20)

7. The holding company group will be subject to consolidated capital adequacy requirements. (p. 21)

8. Closely held banks will also be permitted to organize under a regulated holding company. (p. 22)

Merger Review Process

9. A Merger Review Process will be applied to banks that wish to merge, where both banks have equity in excess of $5 billion. (p. 22)

10. The Merger Review Process will require applicants to prepare a detailed Public Interest Impact Assessment (PIIA) for release to the general public. (p. 23)

11. The House Finance Committee will be asked to consider the PIIA and to conduct public hearings into the broad public interest issues that are raised by the merger as proposed. (p. 23)

12. Concurrent with Finance Committee hearings, the Office of the Superintendent of Financial Institutions and the Competition Bureau will review the proposal, from the perspective of safety and soundness and market competition, respectively. These reports will be made public. The Minister of Finance will then decide whether the proposal will be allowed to proceed in light of any prudential, competition and other public interest concerns. If the proposal raises concerns which can be met by imposing conditions, the merger will proceed only if these conditions are met. (p. 24)

13. Legislation will be introduced to provide the Minister with the authority to require enforceable undertakings of applicants for mergers or acquisitions. (p. 26)

Taxation

14. The federal government will raise with the provinces the effects of capital taxation on the financial services sector. As part of these discussions, the federal government is committing to a review of its own capital taxes. (p. 27)

15. The government will review the issue of withholding tax rates in the context of tax treaty negotiations with other countries. (p. 27)

Fostering Domestic Competition

The New Size-Based Ownership Regime

Ownership Rules for Banks

16. The government will implement a new ownership regime for banks based on equity. The new rules will have three classifications: small (less than $1 billion), medium ($1 billion to $5 billion) and large (greater than $5 billion). (p. 31)

17. The large banks, those with equity in excess of $5 billion, will be widely held. (p. 32)

18. Medium-sized banks, those with equity between $1 billion and $5 billion, will be allowed to be closely held. Closely held medium-sized banks will be required to have a public float of 35 per cent of voting shares. (p. 32)

19. Small banks, those with equity of less than $1 billion, will have no ownership restrictions other than "fit and proper" tests. (p. 32)

20. For existing Schedule I banks with equity under $5 billion, their widely held status will be maintained. However, there may be circumstances where it could be advantageous for one or more of these banks to consider a closely held structure. Therefore, if requested by the individual institution, the Minister of Finance will have the discretion to change the status of these banks to the new regime for banks under $5 billion. (p. 32)

Ownership Rules for Non-Bank Financial Institutions

21. Demutualized life insurance companies will have a two-year transition period from the time of demutualization during which time they will remain widely held. No mergers among, or acquisition of, demutualized firms will be permitted during this period. (p. 34)

22. Following the transition period, large demutualized insurers, those with equity in excess of $5 billion, will be required to be widely held. (p. 34)

23. At the time of demutualization, insurers with equity under $5 billion will remain widely held. If requested by the institution, the Minister of Finance will have the discretion to permit them to change their status to closely held under the new regime. (p. 34)

24. If permitted to become closely held, medium-sized demutualized insurers, those between $1 billion and $5 billion in equity, will be subject to the 35-per-cent public float requirement. (p. 34)

25. If permitted to become closely held, demutualized insurers with equity of less than $1 billion will have no ownership restrictions other than "fit and proper" tests. (p. 34)

26. The threshold above which trust companies, stock life insurance companies and property and casualty insurance companies must have a 35-per-cent public float will be raised from $750 million to $1 billion. (pp. 35-36)

Reduced Minimum Capital Requirements for Financial Institutions

27. The minimum capital required to start a financial institution will be reduced from $10 million to $5 million. (p. 36)

Accommodating the Initiatives of the Credit Union Movement

28. The government will introduce legislation to provide for a restructured, two-tier credit union system with an enhanced national presence. (p. 38)

29. The government will work with interested credit unions to determine what legislative steps may be taken to accommodate a co-op bank structure. (p. 38)

Expanding Access to the Payments System

30. Access to the payments system will be broadened to accommodate the entry of life insurance companies, securities dealers and money market mutual funds. (p. 40)

Empowering and Protecting Consumers of Financial Services

Ensuring Access

31. The government will legislate key elements of the 1997 agreement with the banks on access to basic services. Banks will be required to open accounts and cash federal government cheques for any individual who meets certain basic identification requirements, provided there is no reason to suspect fraudulent activity. Neither employment nor a minimum deposit will be required to open an account. (p. 48)

32. The government will introduce regulations requiring banks to clearly disclose their hold policies to customers. (p. 48)

33. The government will introduce legislation requiring banks to offer a standard low-cost account that includes a certain number of non-electronic transactions, and prominently post information on their availability in branches. (p. 49)

34. The government will require federal deposit-taking institutions to provide four months' notice of branch closures and post notice of the closing date in the affected branch. In rural areas without another financial institution within a 10-kilometre radius of the closing branch, six months' notice will be required. (p. 51)

35. For branch closures in rural or low-income inner-city areas with only one branch of a deposit-taking institution, the new Financial Consumer Agency will be able to convene a consultation of stakeholders if there are concerns that insufficient consultation is taking place. (p. 51)

36. The government will monitor federal deposit-taking institutions' progress toward full wheelchair accessibility. (p. 53)

Financial Consumer Agency

37. The government will establish a new Financial Consumer Agency (FCA) to enforce the consumer-oriented provisions of the federal financial institution statutes, monitor the industry's self-regulatory initiatives, promote consumer awareness, respond to consumer enquiries, and direct the calls of consumers with complaints to the appropriate body. The FCA will consolidate and strengthen existing oversight activities currently dispersed among various federal entities. (pp. 54-55)

Canadian Financial Services Ombudsman

38. The government will work with the industry to establish the Canadian Financial Services Ombudsman (CFSO), a not-for-profit corporation that can accept any financial institution as a member, to provide impartial, non-legalistic dispute resolution services. The CFSO will operate independently of government and financial institutions. (pp. 55-56)

39. Banks will be required to join the CFSO. Other federal financial institutions will be required to be members of a third-party dispute resolution system. These institutions, and provincially incorporated financial services providers, will be welcome to join the CFSO. (p. 56)

40. The CFSO will report annually to the Minister of Finance and the public on the number of complaints received, the results of its involvement and the time it takes to resolve complaints. (p. 57)

Promoting Good Business Practices and Accountability

41. The federal government will hold discussions with the provinces and the industry to work towards enhancing transparency and disclosure of financial service sales documents and contracts. (p. 58)

42. In order that the government be able to respond to disclosure problems as new products and services emerge, it will amend the financial institution statutes to provide for regulation-making authority governing disclosure. (p. 58)

43. The government will regulate the disclosure of risks associated with index-linked deposit products offered by federal deposit-taking institutions. (p. 58)

44. The existing *Bank Act* provision on tied selling, which prohibits a bank from coercing a customer to purchase a product as a condition of obtaining a loan, will be extended to prohibit a bank from coercing a customer to purchase a product as a condition of obtaining any other product. (p. 60)

45. The government will require banks to disclose to consumers the fact that coercive tied selling is illegal, prior to entering into a combination of financial transactions. (p. 60)

46. Federal financial institutions with equity in excess of $1 billion will be required to publish annual Public Accountability Statements that describe an institution's contributions to the Canadian economy and society. (p. 61)

47. The government will undertake a comprehensive program of data collection and analysis to ensure that there is adequate information on the financing needs of small and medium-sized enterprises (SMEs) for effective public policy development:

- Statistics Canada will be given the mandate to collect and publish data on the supply of debt and equity financing to SMEs. (p. 62)
- Industry Canada will be given the mandate to establish a dedicated SME Finance Group to analyze the Statistics Canada data, conduct other surveys and undertake continuing research on SME financing issues. (p. 62)
- Industry Canada will report annually to the House of Commons Standing Committee on Industry regarding the state of SME financing in Canada. (p. 62)

Improving the Regulatory Environment

48. The government will change the mandate of the Canadian Payments Association (CPA) to better define the Association's role in the payments system and to establish its responsibility to advance the public interest. The CPA will be required to facilitate, rather than plan, the development of the system. (p. 69)

49. The CPA Board will be expanded from 11 to 15 members. The Board will consist of 11 CPA members (5 bank, 6 non-bank), 3 independent directors and 1 director from the Bank of Canada. (p. 69)

50. The CPA's Stakeholder Advisory Council will be enshrined in the CPA Act. (p. 69)

51. The Minister of Finance will have a maximum of 30 days following receipt of a new or amended CPA rule to disapprove it, if it is found contrary to the public interest. (p. 70)

52. The Office of the Superintendent of Financial Institutions (OSFI) will no longer be required to perform an examination of and report annually on CPA activities. (p. 70)

53. The Minister of Finance will have the authority to designate other payments systems for oversight. (p. 70)

54. The Minister of Finance will have the power to issue a directive to the CPA and other designated systems to require a change in a by-law, rule or operating practice which the Minister determines to be contrary to the public interest. (p. 70)

55. The Canada Deposit Insurance Corporation's standards by-laws will be updated and a number of changes will be put in place to streamline the associated administrative processes. (p. 73)

56. OSFI will have additional supervisory powers that would increase the consequences for any institution that fails to meet certain regulatory or supervisory requirements, in particular:

    - A new authority that would allow the Superintendent to remove directors and senior officers from office in certain circumstances, such as instances of misconduct.
    - A system of administrative money penalties for financial institutions and individuals that fail to comply with undertakings and cease and desist orders, or violate financial institution legislation and regulations.
    - Measures to enhance the Superintendent's power to deal with related party transactions of financial institutions. (p. 74)

57. OSFI will introduce a new notice-based approval process for many of the applications requiring the Superintendent's approval. Applications will be automatically approved 30 days following their receipt provided that the Superintendent does not raise concerns, seek further information or require a delay. (p. 75)

Annex B

Sector Overview

Despite the tendency to discuss financial sector policy largely with reference to the largest domestic banks, the sector is more complex and dynamic than this would suggest. A wide range of firms of different types, regulated and unregulated, domestic and foreign, are already active in the Canadian market.

In addition to the traditional regulated financial institutions with an extensive history, Canadian consumers can increasingly turn to a small but growing number of new, unregulated financial service providers. While their share of total financial sector industry assets is still small, it can be expected that this share will grow over time.

> "Canadians today can choose from a wider range of suppliers of financial services than at any other time in our history...."
> Task Force on the Future of the Canadian Financial Services Sector, *Change, Challenge, Opportunity: Competition, Competitiveness and the Public Interest*, Background Paper #1, September 1998, p. 35.

The table below summarizes the main economic indicators for the major components of the sector.

Financial Services Sector Overview, 1997

	No. of companies	Total assets ($ millions)	Capital ($ millions)	Total revenue ($ millions)	Net income ($ millions)	No. of employees	Notes
Banks (includes subsidiaries)	55	1,322,085	54,699	42,124	7,954	219,977	1, 2, 3
Canadian	11	1,229,864	49,767	39,629	7,550	211,398	1, 2, 3
Foreign	44	92,221	4,932	2,494	404	8,579	1, 2, 3, 4
Trusts (excludes bank subsidiaries)	23	52,178	2,418	2,353	553	22,900	1, 3, 5
Credit unions and caisses populaires	2,315	121,100	6,825	5,905	567	61,600	3, 5, 6, 7, 9
Provincial government-owned banks	2	11,131	n/a	337	92	3,361	3, 8
Federal life insurance companies	121	279,774	28,002	59,726	2,771	60,770	1, 3, 5, 9
Canadian	54	255,826	23,629	54,213	2,386	n/a	1, 3, 9, 11
Foreign	67	23,948	4,373	5,514	385	n/a	1, 3, 9, 12
Provincial life insurance companies	26	13,920	n/a	n/a	n/a	n/a	10
Property and casualty insurance companies	216	53,014	15,513	19,110	1,866	37,055	1, 3, 5, 9
Canadian	97	37,105	n/a	13,985	1,363	n/a	1, 3, 11
Foreign	119	15,909	n/a	5,125	503	n/a	1, 3, 12
Securities dealers (includes bank subsidiaries)	187	158,200	3,526	8,478	769	32,900	13
Mutual funds	73	283,159	n/a	n/a	n/a	35,000	14

n/a means not available

Notes:

1. Source: OSFI as at December 31,1997.
2. Number of employees is full-time equivalent.
3. Total revenue is defined as the sum of net interest income plus other income.
4. This estimate assumes that full-time equivalent employment equals 85% of total employment.
5. Source for number of employees: Task Force on the Future of the Canadian Financial Services Sector, *Change, Challenge, Opportunity: Competition, Competitiveness and the Public Interest*, Background Paper #1, September 1998, p. 38.
6. Sources: Credit Union Central of Canada and the annual report of Le Mouvement Desjardins.
7. Source: Statistics Canada, Catalogue no. 61-008-XPB, fourth quarter 1998.
8. Sources: annual reports of Alberta Treasury Branches and the Province of Ontario Savings Office.
9. Source for Capital: Task Force, Background Paper #1, p. 38.
10. This estimate excludes assets of SMDA Insurance Corp, for which data were not available.
11. Includes Canadian subsidiaries and foreign companies.
12. Comprised of Canadian branches of foreign companies.
13. Source: Task Force, Background Paper #1, p. 38.
14. Source: Investment Funds Institute of Canada (IFIC). Number of employees was estimated by the IFIC; includes employees of bank-owned funds (also included in banks' figures).